

Vol. XVII, No. 22
November 8, 1982

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

81900-1 11/8/82

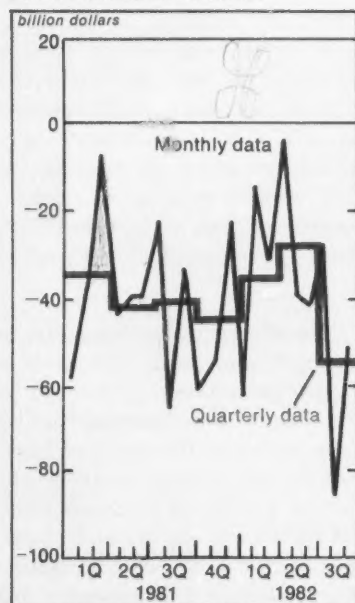
The U.S. Current Account Moves Into Deficit

After tending toward balance or small surplus since 1978, the U.S. current account appears to have turned negative. Although data on recent service payments are not yet available, the swing in the trade balance appears to have been strong enough to result in a deficit on current account of close to \$4 billion in the third quarter. Over the first half of the year the current account was in *surplus* by \$3.5 billion. Thus, although fourth-quarter performance should be somewhat stronger than that of the third quarter, the U.S. current account now seems destined to show a small deficit for the year as a whole. If, as seems likely, the economic rebound next year is stronger in the United States than in the rest of the world, the U.S. current-account deficit for 1983 could be relatively large—perhaps \$15-20 billion.

It is fashionable to ascribe this turnaround to the strength of the dollar. But while the strong dollar has certainly tended to curb exports and encourage imports, the surge in the third-quarter trade deficit was more the result of other economic forces: including a pickup in oil imports stemming from inventory increases and the general slowdown in world trade. While American exports have fallen steadily since the first quarter of 1981, the U.S. share of all industrialized country exports has been fairly stable since mid-1981. Over the past 15 months, the decline in U.S. exports thus appears more related to the worsened growth performance of America's major trading partners, particularly Canada and the developing countries, than the worsened competitive position of U.S. exporters. The role of the strong dollar is somewhat more evident on the import side. While the dollar value of non-oil imports has been reasonably stable since mid-1981—and has actually declined relative to nominal GNP—the volume of imports and the ratio of imports to GNP in constant prices have continued to rise.

The outlook for a worsened U.S. current account performance is not only a matter of a larger deficit in merchandise trade, however. After increasing steadily since 1975, the huge U.S. surplus in services transactions appears likely to shrink somewhat next year. This is due in part to the outlook for lower earnings from U.S. direct investments abroad. But the key element here is the prospect of declining net foreign interest receipts resulting from lower Eurodollar interest rates. Even a good wind blows some ill.

U.S. trade balance*



*Seasonally adjusted annual rate, f.a.s.-c.i.f.

New Dutch government plans stringent policies to help tame deficit.

Despite economic downturn, reduction of current-account deficit remains primary Icelandic goal.

Signs of an economic turnaround for Argentina.

Israeli economy suffers few ill effects from Lebanon conflict.

Despite Holland's continuing recession—industrial output has been basically flat for almost two years—the country's soon-to-be-inaugurated government has agreed to a policy of austerity. A center-right Christian Democrat-Liberal coalition with a comfortable 12-seat parliamentary majority is about to form a government that will be led by Ruud Lubbers, a former economics minister and successor to Dries van Agt as the head of the Christian Democrats. The new government hopes to reduce the Netherlands' public-sector deficit to less than 10% of national income from an estimated 10.5% in 1982. Spending cuts of 13 billion guilders—larger than previously planned—are envisaged for 1983, and tax thresholds will be less than fully adjusted to the inflation rate. Nevertheless, because exports account for over half of the country's GDP, the main influence on economic growth will be developments in the remainder of the EEC, where demand is expected to remain weak at least until mid-1983.

The Icelandic economy is now entering a downswing. The country's all-important fish catch will be close to one-half of its 1981 level, while prospects for energy-intensive exports, such as aluminum and ferrosilicon, have been dimmed by the continuing world recession. Current forecasts point to a 3.5% decline in GNP in 1982, following a 1.5% increase in 1981. The current-account deficit is expected to swell to some 10.4% of GNP, compared with last year's 4.9% figure. Despite mounting political pressures as the next election draws nearer—it is generally expected before the spring of 1983—the government has made it clear that a reduction in the current-account gap is its main objective, ruling out any counter-cyclical policies that might endanger this goal. As a result, most forecasters are expecting a narrowing of the payments gap to some 6.0% of GNP in 1983, while GNP itself is expected to decline by a further 2.7% compared with 1982's figure.

The Argentine economy is beginning to show signs of revival after 18 months of declining activity. Since early 1981, the country's business and industrial sectors have been buffeted by soaring inflation, high interest rates, foreign-exchange instability, and war dislocations in trade and finance. Now, owing to the government's program of negative real interest rates and trade and exchange controls, sales and production have started to pick up in some sectors. Moreover, manufacturing turned up slightly over July-September, the agricultural sector is enjoying an excellent grain harvest, and the government recently adopted a new unified exchange-rate system. But despite these encouraging developments, the country still faces a 175% rate of inflation and deep concerns about its external debt and reserves position. An IMF standby program, currently being formulated, could help to alleviate these problems. Such an agreement might not only aid in price stabilization, but also shore up Argentina's foreign reserves and its debt-servicing capabilities.

The Israeli economy so far has shown no signs of any major disruption as a result of the conflict in Lebanon. Real GDP growth may be as high as 4% this year, following growth of 4.7% in 1981. The principal sources of strength have been private consumption and the surprising buoyancy of investment. The prospects for 1983, however, are not quite so bright, owing to the recent tightening of fiscal policy and continued recession in Israel's major overseas markets. Moreover, the economy remains beset by inflation and balance-of-payments difficulties. The world recession has limited demand for Israeli exports and played a part in what is likely to be a \$500 million deterioration in the civilian deficit on goods and services this year. Overall, the current account will register a deficit similar to the \$1.5 billion gap recorded in 1981. Finally, inflation may average around 125% in 1982 after last year's 116.8%. The increase reflects, in large part, a deliberate move by the government to reduce subsidies on many items in the first half of the year. More recently, however, this policy has been reversed, suggesting a slower pace of price rises in the latter part of the year.

*Bond markets
rally
in Australia.*

Falling interest rates, new debt issuance procedures, and a striking inflow of foreign capital have drawn increasing attention to the Australian capital markets in recent months. Long-term interest rates have dropped off sharply. For example, successful tenders for the A\$675 million in government bonds offered in September produced yields about 130 basis points below those produced by a A\$350 million issue last July. Yields continued to fall in the secondary market as well, until the new bonds were priced to yield about two percentage points less than two months previously. And the downtrend in rates is expected to continue. In addition to the rate decline, the Australian financial markets have been getting a boost from the successful introduction of a new tender system for selling government bonds and from heavy investment by Japanese financial institutions. Capital inflows in September rose to A\$1.68 billion from A\$346 million in August. And most of the A\$600 million invested in government and quasi-government securities represented Japanese capital. The influx of Japanese funds not only will help to hold interest rates down, but also should tend to slow the fall of the Australian dollar.

*Chile hopes to cut
unemployment, return to
positive growth.*

Chile is attempting to pull out of its currently depressed level of economic activity. The economy now faces the prospect of a 13% drop in real growth this year. This would be a striking turnaround from the previous five years when real GDP expanded at a rate of 7.8% per annum. Industrial output and retail sales are considerably below their year-ago levels, and unemployment has climbed to 24%. The economic downturn has been blamed largely on international recession, high world interest rates, soft export prices for copper, and an overvalued exchange rate. And now—although it will inevitably mean an increase in inflation from the unusually low annual rate of 4.5% posted in the second quarter—the Chilean government is trying to stimulate a recovery by establishing a regular crawling-peg devaluation of the currency in the hope of boosting exports. At the same time, a \$900 million IMF assistance program is being secured to rebuild reserves.

*Foreign investment
up sharply
in Taiwan.*

Taiwan's Ministry of Foreign Affairs has released statistics indicating that foreign direct investment rose an extraordinary 83.8% in the first six months of 1982 compared with the same period last year. By far the largest share—some 55%—of the total \$212.1 million invested represented Japanese funds, while U.S. investments accounted for 22% or \$46.9 million. Given the severity of Taiwan's current economic slump, such inflows are welcome. Real growth reported thus far this year has averaged only around 3.5%—notably lower than 1981's 5.5% and far below the 8% annual growth target set by the government's latest four-year plan. Most forecasters are calling for an extremely slow recovery as Taiwan continues to await a turnaround in world demand for its exports. Nevertheless, foreign investors undoubtedly have great confidence in the country's long-run outlook.

*No turnaround
in sight yet for
world wheat market.*

World wheat production for 1982/83 is forecast at 449.0 million metric tons—less than 1% below last season's record level of 453.3 million tons, but still above earlier forecasts. Higher-than-expected output in the United States, Argentina, Mexico, Europe, and South Africa will offset (in terms of world trade) Australia's crop loss from drought and the Soviet Union's production decline. Weak world consumption is expected to continue, causing stock buildups for the second consecutive year and leading to continued downward pressure on already low prices. Canada, Argentina, France, and Australia are gaining USSR import commitments even as U.S.-Soviet trade declines. U.S. stocks will probably absorb most of the excess production because of the current USSR pursuit of decreased dependence on American grain. As Soviet crops improve, import needs will continue to decline, constricting the market for U.S. exports even further.

Capital Spending Outlook Not So Bleak

Unquestionably, the most glaring negative element in the preliminary third-quarter GNP figures released by the Commerce Department was the 13% decline in real non-residential fixed investment. This represented more than an 8% reduction in investment in structures and a 15% cut in equipment spending. Prospects for future capital spending are similarly dim. But while it is true that a recovery in business investment will lag behind the turnaround in production, several forces are already at work to improve its outlook.

The strongest argument *against* the prospect of a rebound in capital spending is the less-than-70% level of capacity utilization. The notion is that as production expands, corporations will first use existing plant and equipment before buying new machinery. However, this does not mean that firms will use *all* the available capital stock before expanding capacity. Technological progress, particularly in such heavy industries as steel, has rendered much of the existing equipment obsolete. As a result, the appropriate level of full utilization is much less than 100% and, in fact, has been falling over time. At the last cyclical peak, capacity utilization was 85%; this time, it might be around 82%. And even this figure is only a broad average, which masks much lower capacity constraints in some industries.

Another consideration is the sharp drop that has occurred in interest rates, especially in long-term bond yields. Moreover, although further modest improvement can be expected in inflation, the recent change in Federal Reserve policy creates the circumstances for an easing of monetary pressures and a further decline of interest rates well into 1983. As a result, there should be significant progress in reducing the level of real interest rates. This development will improve the prospective profitability of investment projects and encourage capital spending.

Finally, recent legislative changes, which many observers felt would discourage business investment by repealing safe-harbor leasing, actually contain sufficient positive provisions to ensure no real reduction in these activities. Specifically, although lessors who buy tax benefits from ailing lessees through sale-and-leaseback agreements must spread out investment tax credits and depreciation allowances over longer periods, several industries—such as steel, automobiles, and aircraft producers—obtained deadline extensions. Moreover, in January 1984, when most safe-harbor leasing transactions will be phased out, a new type of lease, called a "finance" lease, will be phased in. This will permit many of the same type of tax transfers sanctioned under the safe-harbor leasing.

Carl Alan Batlin

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS				
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of credit, billions of dollars
Algeria	Government spending expected to grow by 10% in 1983.	Aug.	-31%	36.0*	1,935	Sept.	2,555	-32%	1.0	0
Congo	Extensive road building program begun to aid development of agricultural sector.	Dec.	+18%	1.2	735	May	112	-20%	1.7	0
Egypt	New law introduced to encourage investment.	May	-31%	22.7*	535	Aug.	597	-10%	0.8	65
Liberia	Gov't. budget for fiscal 1982-83 is \$420 million, \$11 million below year earlier.	June	-17%	1.1*	570	Sept.	10	-55%	0.3	124
Morocco	Economy expected to grow by about 5% this year.	May	-4%	18.1*	896	Aug.	143	-16%	0.4	763
Nigeria	Planned \$2.5 billion railway postponed indefinitely owing to financing difficulties.	Aug.	-13%	86.8	1,125	Aug.	1,399	-82%	1.0	0
South Africa	Rapid inflation, high interest rates, and rising unemployment pare back consumer spending.	Aug.	-16%	78.4	2,601	Sept.	602	+48%	0.4	0
Sudan	Greater incentives to farmers raise commodities output; cotton crop up dramatically.	March	-26%	9.0	482	Sept.	26	+5%	0.3	49
Tanzania	Industries running at about 35% of capacity.	Sept. '81	+24%	6.2	338	April	15	-33%	0.2	8
Tunisia	Sixth five-year plan launched; job creation a priority.	July	-14%	8.1	1,240	Aug.	530	-8%	1.8	0
Uganda	Private investors return to tea estates and sugar industry.	n. a.	n. a.	3.5*	280	n. a.	n. a.	n. a.	n. a.	24
Zambia	Shortages of materials sharply curtail manufacturing output.	Dec.	-23%	3.4	575	Aug.	63	+21%	0.6	64
Zimbabwe	Real GDP growth expected to slow to 3% this year, could turn negative in 1983.	Dec.	-15%	6.7	870	Dec.	230	-3%	2.0	40
Jordan	Industrial production grew only 0.6% in first half of 1982.	March	+24%	4.5	1,341	Sept.	953	-18%	3.5	0
Kuwait	Gross value of outstanding forward-dated stock market checks officially put at \$91.6 billion.	May	-30%	24.3	17,350	Sept.	4,691	+21%	7.2	0
Qatar	No decision made yet on exploitation of gas reserves.	Aug.	-27%	5.0*	23,000	Sept. '81	347	-10%	2.3	0
Saudi Arabia	Public Investment Fund's domestic loan commitments rose to \$23 billion at midyear.	Aug.	-32%	155.8	16,719	Sept.	30,330	+3%	10.8	0
United Arab Emirates	Government agrees in principle to establishment of local stock market.	June	-21%	29.8	29,780	Sept.	3,156	+12%	4.1	0

*1980

Sizing Up the New Deposit Service

Commercial banks and thrift institutions will soon be offering their customers a new money market deposit account. Although it should prove popular with depositors, the new account still faces some problems that could limit its attractiveness.

Recent legislation directed the Depository Institutions Deregulation Committee (DIDC) to issue regulations, which would take effect in mid-December, authorizing an account that is "directly equivalent to and competitive with money market mutual funds . . ." The DIDC has already indicated that the new regulations will reflect: (1) no minimum maturity, (2) no interest-rate ceiling, (3) an initial minimum denomination no greater than \$5,000, (4) up to three pre-authorized or automatic transfers and three other third-party payments (including drafts) per month without being subject to transaction-account reserve requirements, (5) availability to all depositors, and (6) deposit insurance up to \$100,000.

A decision is imminent on a number of important issues that the DIDC will have to resolve. First, although the new account, as described by the DIDC, would ". . ." not be subject to transaction account reserves ". . ." so far there is an ominous silence about other reserve requirements. While under 1980 legislation Congress eliminated reserve requirements on time deposits held by individuals, "non-personal" reserve requirements could conceivably be imposed by the Federal Reserve.

Second, the DIDC is apparently deferring action on

a new account having unlimited payments features. Adoption of such an account would substantially enhance the efficiency of the payments system.

Third, the DIDC is considering imposing minimums on initial deposits to the account, balances to be maintained thereafter, and transfers. Limitations are also under review covering credit connected to the account, telephone transfers to other accounts of a depositor, and deposits to the account.

Two conclusions can be drawn from events to date. First, although congressional intent is reasonably clear (despite some fuzziness in the statutory language), regulatory embellishments threaten to curb the attractiveness of the account. Indeed, some steps now under consideration would constitute "re-regulation." While the account will no doubt be attractive, as both a saving and limited transacting vehicle, it could be better.

Second, virtually any success for the account will reduce recorded M1 growth during 1983, thereby providing considerable latitude for Federal Reserve policy. As a result, of course, M1 probably will be even less useful as a gauge of monetary policy during 1983 than it was in 1982. That suggests—assuming no changes in the definitions of the aggregates—that M2 is likely to take on greater importance relative to the other policy variables. However, it does not necessarily follow that M2 will have the major policy role in 1983 that M1 had during much of the past three years.

Richard C. Aspinwall

PAYMENTS		MONEY AND BANKING							COUNTRIES
current influences on payments	latest data	12-month changes		latest data	money supply(M1)	exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
	consumer prices					November 3, 1982			
Gas exports forecast to reach \$4 billion in 1983.	Dec. '80	+10%	Dec. '81	+16%		.2153	— 8%	Admin. procedures reported to have delayed payments.	Algeria
Oil companies increase capital imports for exploration and development.	Dec.	+13%	May	+19%		.002766	—23%	Time deposits on steady up-trend.	Congo
Oil export revenues were \$2.7 bn. in FY 81/82, unchanged from previous year.	June	+16%	July	+26%		.9879	—20%	June private credit up 59.3% from year earlier.	Egypt
IMF loan of \$89 million will assist balance of payments.	June	+ 6%	March	— 4%		Par	—	Private-sector liquidity increased in second quarter.	Liberia
Current-account deficit projected at \$1.9 bn. for 1982, up slightly from 1981.	March	+15%	Feb.	+15%		.1600	—14%	Growth of claims on private sector slows.	Morocco
Import deposits for raw materials and spare parts to be cut to 10% from 25%.	Dec.	+17%	June	+ 5%		1.4700	— 4%	Accumulated trade debts now at \$3.5 billion.	Nigeria
Current-account deficit narrowing because of higher gold prices and lower imports.	Aug.	+14%	July	+24%		.8610	—18%	Post office enters the capital market.	South Africa
Foreign indebtedness now estimated at \$6.8 billion.	n. a.	n. a.	July	+28%		1.1100	—16%	Further devaluation of currency likely.	Sudan
IMF and World Bank aid being actively sought.	Dec.	+23%	n. a.	n. a.		.1809	n. a.	Foreign reserves virtually depleted.	Tanzania
Current-account deficit this year officially forecast at \$680 million.	May	+13%	July	+14%		1.5620	—24%	May private-sector credit growth rose to 29%.	Tunisia
World Bank loans to aid imports of critical spare parts, raw materials.	n. a.	n. a.	April	+55%		.0101**	—19%	Two-tier exchange-rate system introduced.	Uganda
Foreign-exchange decline causes severe restrictions on non-essential imports.	Sept. '81	+15%	May	+ 5%		1.0478	— 8%	IMF seeks devaluation of kwacha.	Zambia
Restraints hold imports at one-third below mid-1981 levels.	March	+13%	April	+ 6%		1.3000	n. a.	Likelihood of devaluation increases.	Zimbabwe
First-quarter 1982 exports 33% above year-earlier level.	July	+ 7%	June	+13%		2.7816	— 5%	M2 growth declined to 18.2% in July.	Jordan
Oil production remains flat at 650,000 barrels per day.	Dec.	+ 7%	July	+50%		3.4471	— 3%	Liquidity remains tight.	Kuwait
September oil output down to 287,000 barrels per day.	n. a.	n. a.	Dec. '81	+50%		.2748	0	Money supply growing more slowly.	Qatar
Oil production only 5.8 million barrels per day in August.	June	— 1%	April	+21%		.2908	— 1%	Domestic liquidity tighter.	Saudi Arabia
Oil production steady at 1.15 million barrels per day.	n. a.	n. a.	July	+15%		.2724	0	June private credit rose 14.5% year-on-year.	United Arab Emirates

** most items

World Interest Rates

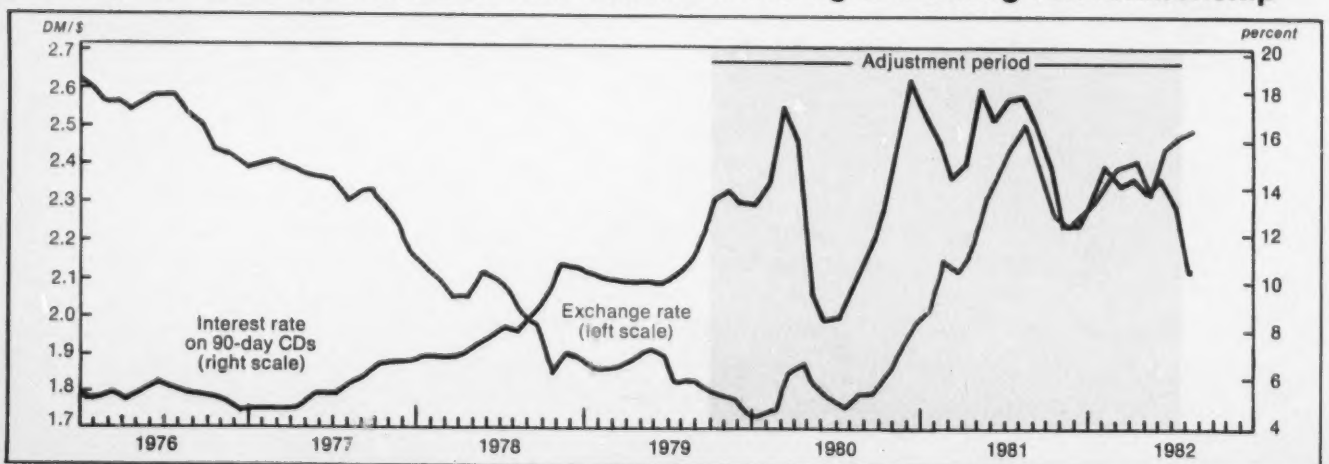
market rates of Nov. 3, 1982; bond yields as of Oct. 29, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.50	11.46	9.625 intervention rate	12.00	9.50	6.00	18.00 penalty rate 21.00	6.00	5.00	5.50*
Day-to-Day Money	9.375 November 4	13.00	9.625	11.80	13.50	7.10	18.75	6.625	1.75 1-month Euro-Swiss fr. rate	7.00*
Treasury Bills 91-day, Middle Rates	7.77	11.05	8.75	12.75	n. a.	n. a.	16.956 87 days	no dealing	no market	5.625* two-month
Commercial Paper prime, 3-month, asked	9.00 finance paper discount basis	11.35 finance paper 15% tax w/h	8.519	11.90 Certified	13.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.80	11.25 15% tax w/h	8.625	11.90 Certified	not traded	8.05	16.90	no market	3.75	no market
Government Bonds Long-term, new and old issues, average yield	10.74	12.20	10.18	8.972 20% tax w/h	15.04	8.10	19.42	9.09	4.30	8.202
Industrial Bonds prime, long-term, new and old issues, average yield	12.05 Aa Industrials	13.00	11.68	14.904	16.10	8.15	19.65	9.62	5.81	6.76
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.75	10.50	16.00	15.20	11.50	20.75 1/4 qtrly fee on outstg.	8.50	8.50	6.00*
Bank Time Deposits 3-month	8.875 Cert. of Dep.	11.25	9.0625	12.55	13.25	7.10	11.50	6.625 large deposits	3.00 residents only	3.755*
Eurocurrencies 3-month, asked	9.625	11.625	9.25	no market	19.50	7.00	no market	6.5625	3.4375	7.125
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8180	1.6750	.0202	.1386	.3892	.000685	.3591	.4520	.0036
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.80 D	.60 P	3.25 D	9.75 D	2.75 P	13.25 D	3.51 P	6.25 P	2.75 P

Eurodollar Deposits (London, interbank, bid) November 4	International Arbitrage (3-month, hedged) + in favor of U.S. dollars	Eurobonds (average yield on recent straight debt issues)	Gold Price
7-day 9.50	U.S.-U.K. Treasury Bills -1.46	U.S. Dollar Bonds	London afternoon fixing
1-month 9.375	U.S.-Canada Treasury Bills -1.036	7 yrs. and under 11.00	
3-month 9.625	U.S.-Canada Finance Co. Paper -0.394	Over 7 yrs. 11.25	
6-month 9.6875	Eurodollars-U.K. Local Auth. Deposits +0.088	DM Bonds	
		7 yrs. and under 8.625	427.50
		Over 7 yrs. 8.50	(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Market rates as of October 27, 1982.

Interest rates and the value of the dollar: Returning to the long-run relationship



Exchange Rates: Back to Long-Run Basics

Foreign-exchange forecasters have had a rough life since the Bretton Woods system of fixed exchange-rates was replaced by an ostensibly floating-rate system that has been sometimes managed and often mis-managed. Since 1971, forecasters have been striving to develop rules of thumb relating to the interrelationships among exchange rates, interest rates, inflation, trade flows, and other economic variables affecting the international financial markets. But just when the forecasting community thinks a dependable rule has been found, it breaks down.

The challenge is clear: A consistent theory of economic behavior is needed to understand the workings of the foreign-exchange markets. As the great 19th century economist Alfred Marshall once put it, the facts are worthless without a theoretical framework. This is particularly true since the "facts," in terms of the observed statistical relationship between such variables as interest rates and foreign-exchange rates, keep changing.

The facts

For example, during the period 1976-1978, forecasters thought they had discovered two critical correlations: (1) When U.S. interest rates rise, the dollar falls, and (2) when the U.S. trade deficit increases, the dollar declines. For most of that period, interest rates, indeed, did rise, the trade balance did deteriorate, and the dollar did lose value on the foreign-exchange markets. The interest-rate effect was attributed to the idea that rising inflation means not only a weak currency but also higher interest rates in order to compensate for the declining purchasing power of the currency. The trade-balance effect was related to actual flows of money across national borders in payment for exports and imports.

In a subsequent period lasting from October 1979 through mid-1982, however, these rules of thumb proved useless: The interest-rate/exchange-rate relationship appeared to be reversed; whenever U.S. interest rates rose, the dollar strengthened. In addition, toward the end of the period, the link between interest rates and inflation was called into question. Inflation was falling and yet interest rates refused to follow.

Moreover, during this time the trade balance rule proved to be ineffective in projecting foreign-exchange movements. Flows of money between countries owing to imbalances in exports and imports were easily offset by capital flows, that is, by the international lending and borrowing of money. And whether the offset was overstated or understated depended on the interest-

rate relationship and not the trade balance at all. Hence, having an accurate forecast of either the U.S. or foreign-trade balances meant nothing to the foreign-exchange forecast without a good projection for interest rates and international capital flows. Consequently, new rules were developed as some forecasters argued that the basic economic relationships had been permanently altered.

Starting in the summer of 1982, still a new relationship began to develop. U.S. interest rates have been declining, and yet the dollar has remained strong. The trade balance, as in the 1979-82 period, is still proving irrelevant to exchange-rate prediction. But in this "post-summer-1982" period, the interest-rate/inflation relationship that was observed over 1976-1978 seems to be returning. This time, inflation has slowed dramatically, setting the stage for declining interest rates within the context of a strong currency. And because of the improved U.S. inflation performance, among other things, capital flows have continued to be the critical variable for making accurate projections of the supply and demand for foreign currencies.

On the face of things, these historical data suggest some rather substantive changes over time in the interrelationships among interest rates, inflation, the trade balance, and foreign-exchange rates. However, those who can learn the lessons of these disparate periods and put them together into one consistent story are more likely to reap the rewards the next time things change. And things will undoubtedly change again.

A consistent approach

Actually, the problem is not nearly so difficult or confusing as it may seem. And in reality, the more things change, the more they remain the same—at least, for those who take the time to understand the underlying processes. The key is understanding a simple version of the long-run underlying relationships between variables—those that have withstood the test of time—and then modifying that simple approach during periods of transition from one government policy stance to another. In the short-run of course, say less than three years, the economy is often in a period of transition after either a major change in government policy or some unexpected external shock, such as the OPEC oil price hikes of 1974. During the adjustment period, some of the long-run relationships are temporarily altered as the economy moves from the "old long run" to a "new long run." And historically, adjustment periods have been anything but smooth.

Exchange Rates: Back to Long-Run Basics *(continued from page 7)*

Still, several fundamental long-run economic relationships must be kept in mind. The most basic of these for exchange-rate analysis is the link between the opportunity cost of holding money—the rate of interest—and inflation. Individuals and businesses simply do not hold on to cash if its value is being eaten away by inflation. Instead, the cash is invested to earn a return that is expected to cover the decline in purchasing power, at least. Borrowers in an inflationary environment, on the other hand, are willing to pay the extra interest because they expect to be repaying their debts in depreciated money.

Over the long run, the connection between exchange rates and inflation is built on exactly the same behavior. If inflationary policies cause the currency of one country to lose its domestic purchasing power relative to that of another country, the inflating country will find its exchange rate depreciating. If this did not happen, then someone would be able to buy goods cheaply in one country, sell them dear in another country, and—after converting the foreign exchange—make a tidy profit. Such arbitrage profits, however, simply do not exist for long—if at all.

Of course, relative inflation rates and exchange rates do not always move in lockstep. Many forces, including transportation costs, as well as tariffs and other trade barriers, cause the observed inflation/exchange-rate relationship to differ in the short run from its longer-term path. Conceptually, however, the long-run relationship is the one to depend on.

This means that, in general, over time, higher inflation portends both higher interest rates and a depreciating currency—as happened in 1976-1978. Furthermore, lower inflation usually foreshadows declining interest rates and an appreciating currency. The United States now seems to have moved into such a period, beginning in late summer.

As for what happened in-between, the 1979-1982 episode can be best explained as the transition period from high and rising inflation to lower and falling inflation. In such an adjustment period, many of the long-run economic relationships are temporarily suspended. Not because they have become any less valid, but because policy changes have real economic costs. In a perfect world, there would be no adjustment costs. The economy could move from one long-run environment to another without friction. In a less-than-perfect world, however, there are two principal reasons this does not happen: First, the future course of government policy—which is the dominant long-run determinant of inflation—is extremely uncertain. And second, people make long-term contracts that are not easily reversed or cancelled when policy changes

course. The first reason leads to the payment of an "uncertainty" premium during any transition period. Since no one can be sure if the policy change is permanent or transitory, bets must be hedged. The second point suggests that mistakes will be made and that penalties for error will be extracted.

The past three years have witnessed a marked shift in U.S. monetary policy that has generated extreme uncertainty in the financial markets. Hence, the adjustment costs have been huge. The transition period, however, now appears to be over. And all of the markets—from bonds, to stocks, to foreign exchange—have begun to move in tandem, consistent with long-run, rather than short-run, market dynamics. It will be an unfortunate forecaster who fails to take note.

Long-run or transition period?

Knowing when the economy is entering an adjustment period is relatively easy. Since it takes a major economic shock, the evening news usually gives the first clue that a critical change has taken place. Such was the case when OPEC boosted oil prices in 1974 and when the Fed announced its major policy shift on October 6, 1979. What is much more difficult, however, is knowing when the adjustment period is coming to an end.

Generally, forecasters should be watchful for a return to long-run consistency in all related markets. The time-tested, long-run relationships suggest that when inflation is slowing, several other events should be occurring simultaneously, since they are all caused by the same underlying forces: (1) the currency should be strong, (2) short-term interest rates should be falling, (3) the bond market should rally, and (4) commodity prices should be depressed. When these variables start moving in tandem, then the adjustment period—the period of confusion—is ending.

Some of the key events, such as the decline in the price of gold and other commodities, began in 1980 and 1981. Some of them are just now being identified. The crucial point is that they all must be happening together. In late summer, when all signs pointed to a continued downtrend in inflation and interest rates started to fall, but the dollar remained strong and gold prices failed to climb toward the sky, it became clear that the long-run was returning.

Of course, this new long-run consistency among the financial, commodity, and foreign-exchange markets could disappear with the announcement of a major new event that would again alter the economic environment and necessitate large adjustments. But until then, it is time to enjoy lower inflation and interest rates and a strong dollar.

Bluford H. Putnam



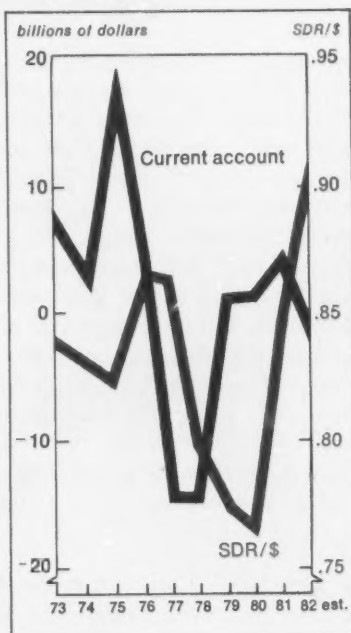
CHASE

International Finance

Vol. XVII, No. 23
November 22, 1982

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

The U.S. current-account balance and the SDR value of the dollar



Does Weakening Current Account Portend a Softer Dollar?

The growing consensus that the U.S. current account will move into significant deficit next year has led many analysts to the conclusion that the dollar is likely to weaken as a direct result. They base this supposition on the apparent correlation between recorded data on the U.S. current-account balance and subsequent foreign-exchange values of the U.S. dollar. The problem with this view is that it stems from a "black-box" model—a hypothesis founded simply on correlations. Such a model is inherently unsatisfactory because it does not incorporate a theory of causation. It is true that since the Bretton Woods system of fixed exchange rates was replaced by a floating-rate system nearly a decade ago, the dollar's value has tended to move—with a somewhat variable delay—in the same direction as the U.S. current account. However, the search for a necessary—or even a highly probable—relationship between changes in the U.S. current-account balance and the exchange value of the dollar appears to come up short.

The fact is that, at least for major swings over the past 10 years, the exchange value of the dollar has responded more to shifts in global preferences for dollar-denominated assets—relative to assets denominated in other currencies—than to current-account developments. These shifts in asset preference, in turn, have been rooted *primarily* in changed perceptions about the tightness of monetary policy in the United States compared with that in other major-currency countries. On the other hand, changes in exchange-rate expectations stemming directly from current-account movements—or from current-account driven charges in the distribution of global wealth—appear to have played a distinctly smaller role in determining the relative preference for dollar assets.

This suggests that in order for the current account to be a reliable predictor of future exchange rates, one of two relationships must hold: Either monetary policy must be driven by current-account developments, or shifts in the relative tightness of national monetary policies must affect goods and services transactions more quickly than they affect asset preferences. Neither proposition is valid. Monetary policy in the United States is not closely related to the U.S. current account. And asset preferences respond much more quickly to perceived changes in the relative tightness of monetary policy than do goods and services transactions. Thus, a deterioration in the U.S. current-account position compared with that of other major-currency countries may or may not presage a fall in the exchange value of the dollar. Only the monetary authorities know for sure!

*Franc devaluation
inevitable unless
French authorities
tighten monetary policy.*

*Economic policy
disagreements spur
resignation of
Italian government.*

*Denmark's new government
aims tough measures
at economic problems.*

*Puerto Rican
economy coming out
of decline.*

French officials are attempting to pin the blame for the recent weakness of the franc on the deterioration of the country's current account. The trade deficit for the first nine months of this year amounted to FF 73 billion—up sharply from FF 38 billion in the corresponding period of last year. Allowing for a declining surplus on invisibles, the current-account deficit may reach some FF 80 billion for 1982 as a whole, following a deficit of FF 26 billion for 1981. Still, a deficit on current-account need not be associated with a falling currency if a country's monetary policy is consistent with its overall balance-of-payments equilibrium. France's loss of reserves is indicative of excess money creation and suggests that the foreign exchange markets view the government's recent austerity measures and price controls as having only a temporary impact on inflation. Nevertheless, the French authorities appear convinced that they can continue to defend the exchange rate and stem the outflow of francs through a range of controls on current and capital transactions without any shift in monetary policy. But unless steps are taken to tighten monetary policy relative to elsewhere in the world, another devaluation of the franc is ultimately inevitable.

Italy's 42nd postwar government has resigned following disagreements within the ruling coalition over economic policy. The main issues are ostensibly the 1983 budget and the stalled three-year wage negotiations—in particular the future of Italy's *scala mobile* system of wage indexation. The public-sector borrowing requirement is now expected to equal some 15% of GDP this year, and, assuming no change in policies, is officially forecast to rise to 17% of GDP in 1983. The employers' federation, Confindustria, has announced the unilateral suspension of the *scala mobile*, effective January 31, 1983. However, most observers believe that an agreement will be reached maintaining indexation in an amended form. Meanwhile inflation continues at a year-on-year rate of over 17% and there is no sign of an economic recovery; industrial production in September fell some 5.8% below its year-earlier level. Not unexpectedly, the lira has come under renewed downward pressure and the Bank of Italy has again tightened exchange controls, requiring export financing in foreign currency. All these developments suggest that the next move in Italian interest rates may well be upwards.

International concern over Denmark's economy has been mounting over the last few years. The current account has been in deficit for two decades and the country's overseas debts now equal almost 50% of GNP. Denmark's complicated political system and extremely comprehensive and expensive welfare system have hindered the introduction of policies to help correct the problems. However, the new government under conservative Poul Schluter has grasped the nettle and introduced a tough set of austerity measures. Wages and profit margins are to be frozen until next March and after that date increases in public-sector pay and in state benefits will be limited to 4% per year. Government spending plans have also been severely pruned. And most important of all, indexation of wages, salaries, and social security benefits will be suspended until 1985. These measures alone, however, will not be enough to lift Denmark out of its difficulties. What is needed is several years of equally tough policies, and it remains to be seen whether Denmark's political system can support such a program. Nonetheless, the new measures are more courageous than most observers had predicted and should lead to an improvement in the world's assessment of Denmark.

A revival of investment activity in Puerto Rico holds promise that the deep economic decline of the past year may be reversing itself. During the fiscal year ending June 1982, Puerto Rican real GNP dropped by 3.9%, the worst performance since the 2% decline of fiscal 1975. All sectors of the economy weakened in fiscal 1982 as a result of U.S. recession, high interest rates, and cutbacks of U.S. government programs for the island. Moreover, uncertainties regarding

legislative proposals for changes in federal tax incentives affecting local investments added to the island's economic problems. The final legislation—incorporated in the U.S. Tax Act of 1982—is considered to have removed these uncertainties by providing clearer rules for investments in Puerto Rico. In the wake of the tax clarification, a number of manufacturing firms have recently announced expansions or new investments. Although these are positive developments, the extent of further recovery will be dependent on the amount of improvement in U.S. industrial activity and interest rates over the next year. With a sufficiently strong revival in the United States, the Puerto Rican economy could return to positive growth by mid-1983.

*Foreign investment
on the rise
in Panama.*

The Panamanian government is seeking to further improve the climate for foreign investment in the isthmian country. Total foreign investment has grown impressively since 1979, bringing foreign investors to prominence in Panama's international banking sector, assembly and light manufacturing industries, and the Colon Free Zone, as well as oil transshipment, exports, and Canal activities. Recognizing the value of these investments, the government recently established a National Investment Council to promote more new enterprises. Perhaps even more important to encouraging investment, however, is the recently signed Bilateral Investment Treaty between Panama and the United States. The new treaty, when it is ratified will provide definite rules for the treatment of U.S. investments and assure the continued free movement of capital. Furthermore, the agreement could serve as a model for other developing countries. Currently, the volume of U.S. investments in Panama totals approximately \$3.2 billion—third largest in the Latin American-Caribbean region after Brazil and Mexico.

*Libya hard hit
by world
oil glut.*

Libya has been one of the OPEC members most adversely affected by the weak oil market conditions of 1981 and 1982. In January 1981, Libya was producing 1.6 million barrels per day and charging an official \$41 per barrel for crude oil. By August of that year, production had dropped to 600,000 bd. In October of 1981, OPEC differentials were adjusted, ultimately reducing prices to \$37. Production rose, but only temporarily, as world oil demand slumped in early 1982. In March of this year, Libya was assigned an OPEC production ceiling of a mere 750,000 bd and prices were reduced further to \$35.50. In recent months, however, the demand for Libyan oil has escalated. Reports currently suggest that production has now reached 1.7 million bd—but on the back of substantial price discounting. These developments have had a serious impact on Libya's balance of payments. Unofficial estimates suggest that 1980's current-account surplus of almost \$11 billion turned into a \$3 billion deficit in 1981. And for 1982—despite cuts in imports—a deficit of \$2 billion is expected. Trade payments difficulties have been reported. However, if current export levels are sustained, these problems should all be settled during 1983.

*Weak commodity demand
and depressed investment
yield lackluster economy
for Malawi.*

With weak demand for its principal exports of tea, sugar, and tobacco and depressed private investment, Malawi's economy continues to stagnate. Despite some improvement in the balance of payments, as lower imports reflected the slowdown in aggregate demand, external borrowings to finance successive current-account deficits pushed the country's disbursed foreign debt to \$700 million by mid-1982—equal to some 70% of GDP. Moreover, Malawi's debt-service obligations rose to over one-third of its foreign exchange earnings. Consequently, debt relief had to be sought and a rescheduling of near-term commercial and bilateral payments obligations is currently proceeding. In addition, the landlocked country's transport situation remains unresolved because of both worsened security on its rail system and congestion at the Mozambican port of Nacala. Although external aid from multilateral sources is expected to continue and there is a possibility of a slight pick-up in inflows of investment capital, the near-term outlook for the Malawian economy remains clouded.

Housing Set for Recovery

Although much of the U.S. economy is sending signals that the recovery may be further delayed, its beleaguered housing industry is beginning to show some definite signs of life. Starts of new housing units edged up to an annual rate of 1.12 million in October—the fourth consecutive month of million-plus performance after lingering below 900,000 for much of the previous year. In addition, sales of new single-family homes jumped to 464,000 in September from an annual rate of 375,000 in August. While these levels are still extremely depressed by historical standards, other changes in the economy suggest that these indicators are bound to improve further and that housing is poised for a modest recovery.

The chief reason the housing outlook now appears more promising is the dramatic decline in mortgage rates over the past few months. The lending rate for government-guaranteed mortgages has dropped to 12% from 15% in August. In response to this, mortgage applications have jumped some 500%.

While financing charges are by far the largest component of the total cost of buying a home, the purchase price is also important. And here, too, prospective homeowners are finally getting some relief. On average, prices of new homes dropped 1.3% in the third quarter—the first decline since 1970—and now are only 2% above their year-ago level. This compares with

yearly gains of more than 10% in the late 1970s. In addition, mortgage subsidies offered by many sellers have helped to lower effective selling prices even further.

An imminent return to the housing industry's boom years in the 1970s, however, is unlikely for several reasons. First, this year's markedly lower rate of inflation is likely to continue next year—and may fall even further. Consequently, the portion of housing demand that stemmed from consumers' desire for a hedge against inflation will be virtually nonexistent. Furthermore, with the current 10.4% rate of unemployment unlikely to show much improvement before 1984, many potential homebuyers may be somewhat apprehensive about taking on a long-term mortgage commitment.

Another consideration is that most savings institutions offer only variable-rate mortgages, which are now relatively less attractive given the large drop in interest rates that has already occurred. And in view of their past losses on even the variable-rate mortgages, savings associations may now choose to take advantage of their newly legislated freedom to make more business loans, which would reduce the overall supply of mortgage money.

On balance, however, the prospects of further moderations of housing price increases and some additional decline in mortgage rates should boost housing activity substantially.

Douglas L. Bendt

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF PAYMENTS			
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in \$ million	12-month change	months of imports covered
Austria	Reflationary 1983 budget proposed in view of continuing recession and rising unemployment.	July	+ 1%	65.8	+0.1%	Sept.	4,645	+ 7%	2.7
Belgium	Government proposes tough budget and incomes policy despite continuing recession.	July	— 1%	96.1	+2.0%*	Sept.	4,460	—14%	0.9
Britain	Modest recovery now forecast owing to slight easing of fiscal and monetary policy.	Sept.	0	523.8*	—1.8%*	Sept.	13,263	—13%	1.6
Denmark	Strong economic growth continues, but slowdown is expected next year in wake of austerity program.	Aug.	+ 1%	55.9	—0.2%	Sept.	1,830	—25%	1.3
Finland	Budget assumption of 2.5% GDP growth after 1% this year is judged to be optimistic.	July	+ 2%	48.5	+1.3%	Sept.	1,041	—31%	1.0
France	Industrialists remain pessimistic over near-term outlook.	Aug.	— 3%	657.8*	+0.5%	Aug.	13,867	—41%	1.4
Germany	Recession intensifying; official forecast now shows 1% real GNP fall in 1982, zero growth in 1983.	Sept.	— 7%	689.4	—0.3%	Sept.	40,510	—14%	3.1
Greece	Economy continues in recession; public-sector deficit overshooting target.	June	—11%	37.7	—0.7%	Aug.	925	+ 4%	1.1
Iceland	Reduced fish catches, poor prospects for aluminium exports suggest GNP decline for 1982-83.	n. a.	—	2.8	+1.3%	Sept.	178	—20%	2.0
Italy	Coalition government resigns on disagreements over economic policy; recession continues.	Sept.	— 6%	350.6	—0.2%	Sept.	15,611	—18%	2.2
Netherlands	New government proposes sharp cuts in spending; output flat while inflation falls.	Sept.	— 4%	140.6	—1.1%	Sept.	8,358	— 1%	1.6
Norway	National budget for 1983 aims for 0.8% increase in GNP.	Aug.	+ 5%	55.6	+0.8%	Sept.	6,870	+26%	5.3
Portugal	Year-on-year inflation receded to 20.7%.	April	+ 6%	23.5*	+5.5%*	Aug.	701	—19%	0.9
Spain	New socialist government not expected to produce radical change of policy.	May	+ 3%	213.1*	+1.2%*	Aug.	9,050	—18%	3.5
Sweden	New government raising taxes to match increased expenditures; slight increase in output expected.	June	— 1%	111.6	—0.8%	Sept.	3,218	—21%	1.5
Switzerland	Real GDP may decline 1.5% this year.	June	— 2%	99.4	+2.8%	Sept.	13,123	+21%	5.6
Canada	Inflation slowing, but unemployment now at 12.7%; real GNP to fall more than 5% this year.	Aug.	—11%	276.4	+3.1%	Sept.	3,027	+40%	0.6
United States	Excess inventories lead to continued production declines.	Sept.	— 9%	2,937.7	+1.9%	Sept.	19,845	+ 7%	0.9

*1980

Will M2 Growth Slow Enough?

The recently released minutes of the October 4 Federal Open Market Committee meeting confirm that the Federal Reserve has decided to focus relatively more attention on M2 as an indicator of monetary growth. Recent statistics indicate, however, that despite a slowdown from its rapid growth during the summer, M2 is still \$11.2 billion above the 9% upper bound of its targeted growth range and, like M1, may easily finish 1982 over target.

The Fed's decision to de-emphasize M1 ostensibly stemmed from its assessment that the more narrowly-defined aggregate was being distorted by technical influences, such as the inflow of maturing All-Savers certificates in October. However, a case can be made that without a change in policy, M1's rapid growth from August thru October—which left it well above its target range—would have forced the Fed to raise interest rates, choking off chances for a 1983 recovery. Thus, the argument that M2 is a more reliable monetary measure is less important to the Fed than the expectation that it will grow more slowly than M1.

M2 contains the transactions balances included in M1 plus such relatively liquid earning assets as money market funds, savings (passbook) accounts, and small time deposits (savings certificates) at banks and savings and loan associations. Therefore, it is reasonable to expect the decline in interest rates that has occurred since July to shift the composition of funds within M2 more heavily into its non-interest-bearing component—M1. This would be the other side of the coin

from what occurred in the latter part of 1981, when high interest rates caused M1 to grow at a rate below target, while M2 finished the year above target.

Through October, M2 grew at a 9.6% annual rate, although this average rate masks its well-above-target growth in July and August. And, while the 5.4% and 8.3% rates of growth in September and October, respectively, are still within the Fed's interim targets for this period, it would be inappropriate to interpret this as support for the proposition that declining rates have been slowing M2 growth.

Disaggregated, the M2 data show that over the first 10 months of the year, the level of savings certificates was rising at depository institutions while passbook account balances were falling. The proposition that M2 growth will now slow down is based on the presumption that the trend in savings certificates will be reversed as rates fall, but the downward trend in passbook accounts will be preserved. In fact, however, October witnessed a reversal of *both* trends: savings certificates fell by \$8.8 billion while passbook accounts rose by \$10.1 billion. What apparently happened was that the maturing All-Savers certificates were not rolled over into new time deposits but instead were deposited into savings accounts. If investors view savings accounts as a liquid medium in which to store precautionary balances while waiting for some resolution of the uncertainty that now characterizes the economic environment, M2 may continue to grow too fast to finish the year within target.

Carl Alan Batlin

PAYMENTS		MONEY AND BANKING						COUNTRIES	
		12-month changes				central bank rate	exchange rate		current monetary conditions
		latest data	consumer prices	latest data	money supply(M1)	November 17, 1982	in U.S. dollars		
years	current influences on payments								
	Current account thru August shows 6.8 bn. sch. surplus, vs. deficit year-earlier.	Sept.	+ 5%	Aug.	+ 4%	6.25%	.0557	Interest rates lowered in line with German rate reductions.	Austria
	Trade balance improving despite weak export markets.	Oct.	+10%	March	+ 3%	11.50%	.0201	Interest rates ease.	Belgium
	Current-account surplus up in Oct., projected to be some \$5 bn. in 1982.	Oct.	+ 7%	Aug.	+15%	9.13%	1.6050	Bank of England helping rates to fall.	Britain
	Current-account deficit remains about the same as last year.	Sept.	+10%	March	+14%	11.00%	.1112	Austerity program points to fall in interest rates.	Denmark
	Jan.-Aug. recorded 69 million markka trade deficit, vs. 558 million year ago.	Sept.	+ 8%	June	+18%	8.50%	.1739	Markets remain calm following October devaluations.	Finland
	Current-account deficit will widen this year to FF 80 billion.	Oct.	+ 9%	June	+15%	9.50%	.1376	Short-term interest rates cautiously eased.	France
	Current account now in broad balance after 17 billion DM deficit last year.	Oct.	+ 5%	June	+ 3%	6.00%	.3891	Discount and Lombard rates reduced again.	Germany
	Current account temporarily improved owing to oil stock reductions.	Sept.	+20%	April	+16%	20.50%	.0136	Money and credit continue to expand rapidly.	Greece
	Current-account now 10% of GNP—near record proportion.	Sept.	+49%	Aug.	+33%	28.00%	.0625	Monetary policy still accomodating 50% inflation rate.	Iceland
	Current account shows small gain on sharply higher tourism earnings.	Oct.	+17%	June	+ 9%	18.00%	.000676	Renewed lira speculation leads to tighter exchange controls.	Italy
	Weak imports and favorable trade shift prompt rise in current-account surplus.	Oct.	+ 5%	July	+ 6%	5.50%	.3584	Guilder strength permits further interest-rate declines.	Netherlands
	Oil and gas exports of kr 50 bn. keeping 1982 current account in surplus.	Sept.	+11%	July	+10%	9.00%	.1370	Reserve requirements lowered following Swedish devaluation.	Norway
	Current-account deficit was \$2.26 billion in first half of 1982.	July	+22%	June	+11%	19.00%	.0108	June M2 growth down to 26.7%, year-on-year.	Portugal
	Peseta weak after election.	Aug.	+15%	July	+14%	8.00%	.00832	August M3 growth eases slightly to 16%, year-on-year.	Spain
	Trade deficit thru Sept. was kr 500 million, vs. 300 million year earlier.	Sept.	+ 7%	Aug.	+11%	10.00%	.1325	Interest rates down slightly after 16% devaluation.	Sweden
	Jan.-Sept. trade deficit was SF 4 bn. vs. SF 6 bn. year ago.	Oct.	+ 6%	July	+21%	5.00%	.4545	Interest rates falling gradually.	Switzerland
	Trade account strong; 1982 may see first current-account surplus since 1973.	Oct.	+10%	Oct.	+ 5%	10.84%	.8163	Interest rates falling even faster than in U.S.	Canada
	Strengthening dollar adds to pressures for rising trade deficit.	Sept.	+ 5%	Oct.	+ 9%	9.50%	—	Soaring monetary growth strains Fed's accomodative stance.	United States

△most recently reported

World Interest Rates

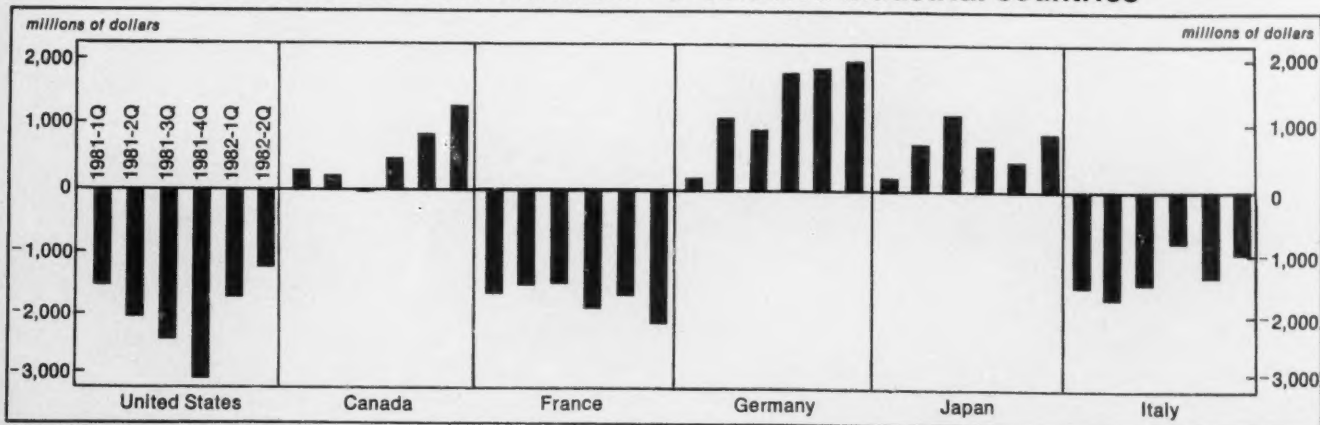
market rates of Nov. 17, 1982; bond yields as of Nov. 12, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.50	10.84	9.125 intervention rate	11.50	9.50	6.00	18.00 penalty rate 21.00	5.50	5.00	5.50
Day-to-Day Money	9.50 November 18	13.00	9.00	11.10	13.125	7.00	18.75	6.125	2.00 1-month Euro-Swiss fr. rate	6.75
Treasury Bills 91-day, Middle Rates	8.36	10.60	8.6875	12.50	n. a.	n. a.	18.249 101 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	9.00 finance paper discount basis	10.75 finance paper 15% tax w/h	8.521	11.80 Certified	13.1875 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.90	10.75 15% tax w/h	8.75	11.80 Certified	not traded	8.05	19.80	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	10.68	12.1875	10.08	n. a.	15.06	8.17	19.96	8.71	4.22	8.122
Industrial Bonds prime, long-term, new and old issues, average yield	11.80 Aa Industrials	13.50	11.52	n. a.	15.90	8.24	19.90	9.13	5.66	6.79
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.00	10.00	16.00	15.20	11.50	20.75 ¼ qtrly fee on outstg.	8.00	8.50	6.00
Bank Time Deposits 3-month	9.10 Cert. of Dep.	10.50	9.125	12.50	13.1875	7.05	11.50	6.625 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	10.00	11.875	9.25	no market	18.125	7.25	no market	6.625	4.1875	7.1875
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8160	1.605	.0201	.1376	.3891	.000676	.3578	.4556	.00381
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.25 D	.875 P	2.5 D	8.0 D	2.87 P	13.65 D	3.5 P	6.0 P	3.0 P

Eurodollar Deposits (London, interbank, bid) November 18 7-day 9.625 1-month 9.6875 3-month 9.875 6-month 10.125	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills -1.083 U.S.-Canada Treasury Bills -0.575 U.S.-Canada Finance Co. Paper -0.353 Eurodollars-U.K. Local Auth. Deposits +0.125	Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 10.75 Over 7 yrs. 11.50 DM Bonds 7 yrs. and under 7.875 Over 7 yrs. 8.75	Gold Price London afternoon fixing 412.50 (per fine ounce)
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Merchandise trade balances* of selected industrial countries



*seasonally adjusted monthly averages, f.o.b. — f.o.b.

The High Costs of Protectionist Farm Policies

International skirmishes over trade in farm products are threatening to erupt into all-out warfare. Miffed at what it views as continued encroachments by the European Economic Community (EEC) on its share of the world agricultural market, the United States has warned that it is prepared to institute competitive export subsidies and to dump its multi-billion dairy surplus on world markets unless some steps are taken to limit the EEC's financing of farm exports at below-market prices.

The protracted world recession has raised the United States' long-simmering resentment of European agricultural trade practices to the boiling point. For the first time in more than a decade, the value of U.S. farm exports has declined during a fiscal year. Despite record volume, the value of American agricultural exports in fiscal 1982, according to preliminary estimates by the U.S. Department of Agriculture, fell by some 8% to \$40.5 billion. The USDA forecasts that net farm income in 1982 will drop to \$19 billion from \$24.5 billion two years ago—in real terms, the lowest level since 1933. Although the appreciation of the dollar is partly responsible for the decline in U.S. farm export receipts, the blame for price instability and lost market shares is more often laid on the EEC's Common Agricultural Policy (CAP). And hard times have spawned a protectionist backlash and talk of retaliation against the CAP.

To be sure, EEC policymakers are not the only ones guilty of engaging in "beggars-thy-neighbor" policies in agriculture. Tariffs, as well as export and import quotas and more subtle nontariff barriers to trade—such as agricultural product health and safety standards, packaging and labeling regulations, and specific customs procedures—exist in virtually every country in some form or another. And the current worldwide economic slump is being used as an excuse to erect all sorts of additional barriers. Policymakers often attempt to justify these restrictions as a means of protecting and supporting a nation's farming industry by insulating domestic agricultural prices from lower prices offered by foreign suppliers.

Economists would generally argue that agricultural policies should theoretically be designed to lead to the use of agricultural resources in ways that will minimize the costs of providing food and fiber, taking into account the comparative advantages of different countries. Unfortunately, however, other competing policy objectives—such as maintaining the "family farm" structure, ensuring "equitable" incomes for farmers, obtaining a certain degree of agricultural self-sufficiency, and stabilizing or reducing food prices in urban areas—generally seem to win out over this goal.

According to studies of agricultural protectionism

presented at a recent conference on international finance and agricultural trade sponsored by the Global Interdependence Center and the American Agricultural Economics Association, the general policy trend in the industrialized countries has been toward programs that prop up domestic farm prices and restrict imports. This drives a wedge between domestic and world prices, often resulting in overproduction and underconsumption of agricultural output and a massive transfer of resources from consumers to producers. Until the mid-to-late 1970s, the effects of such policies were to some extent contained within the borders of the protecting countries. The problem has been compounded, however, by the dumping of the surplus production at subsidized prices onto international markets. As other countries have resorted to restrictive import quotas or some other means of protecting their home markets, the efficient exporting countries have borne the burden.

In the developing countries, on the other hand, farm policies frequently discourage agricultural output by imposing export taxes, government controlled licensing arrangements, price controls, and mandatory storage requirements. Such policies are often defended on grounds of maintaining price stability. However, their effects are generally overconsumption and underproduction of farm output and, frequently, increased price volatility.

The budget costs and true costs to consumers of such policies are never clearly specified—if they are even estimated. And the overall result is often a world in which industrialized countries are overburdened by massive food surpluses at the same time critical food shortages exist in many developing countries.

Expensive policies

The EEC's CAP perhaps is the most highly criticized agricultural support program because of the market-distorting effects of its policies. The CAP subordinates international trade in farm products to domestic producer price considerations through a complex system of tariffs and variable levies. An internal price is politically determined for each of the agricultural products governed by the program (about 90% of EEC output is covered). That price is then maintained through the imposition of variable levies on imports equal to the difference between the "threshold price" and the world price. In this way, would-be exporters to the Common Market are effectively shut out. It has been estimated that the effect of the CAP in terms of lost market shares for countries supplying the EEC over the years 1962-79 totaled some \$28.7 billion in 1980 dollars. Broken down by those countries affected, this amounted to a loss for the indus-

The High Costs of Protectionist Farm Policies *(continued from page 7)*

trialized countries of: \$2.8 billion for the United States, \$2.3 billion for Canada, \$4.7 billion for Australia, and \$7.6 billion for New Zealand. Developing countries, on the whole, lost some \$9.2 billion—almost one-third of the total. This loss of market share, as well as the commodity-price instability caused by CAP policies, has been frequently cited as an important contributor to the developing countries' difficulties in servicing their debt burdens.

As more-efficient, lower-cost foreign producers of farm products are excluded from EEC markets, European consumers also suffer. According to some estimates, EEC consumers have paid as much as five times the world price for milk powder, four times the world price for butter; two-and-a-half times the world price for beef, and one-and-a-half times the world price for grain. More recent statistics indicate that the gap between EEC and world food prices has narrowed somewhat but is still quite wide compared with those of most other countries.

The CAP includes no controls on production, and—because internal Common Market consumption of most of its farm products is stagnant or falling—huge surpluses have arisen. The EEC either subsidizes inferior end-users of the products at home or exports its costly excesses through subsidized sales that enable it to undercut other exporters. In fact, through its subsidized exports, the EEC has greatly expanded its share of the world's agricultural export markets. It is now the world's second largest exporter of beef and for many years has been the largest exporter of dairy products—even with producer prices some two and three times, respectively, the level of the world's efficient producers. Sugar provides an even more dramatic example. Although the commodity is produced at lowest cost in the tropics, the EEC has emerged as a leading sugar exporter—second only to Cuba.

The price of self-sufficiency

Japan is another country whose farm policies have come under strong attack. Achieving and maintaining a certain level of agricultural self-sufficiency has long been a predominant policy goal—one that has proved costly to Japanese consumers. As a result of its program of price supports, input subsidies, and import controls, Japanese families spend some 32% of their disposable income on food, compared with 20% for Europeans and 17% for Americans.

The Japanese government is extensively involved in planning and regulating the agricultural sector. For example, beef production is protected by an annual import quota and a 25% ad valorem tariff; pork prices are stabilized by government purchases and sales of stocks and by a variable duty on imports; a 35% tariff is imposed on imports of poultry, eggs, and dairy

products; and a government agency is the sole buyer and seller of domestic and imported food grains, setting farm purchase prices and resale prices markedly different from world levels. Moreover, although the gradual Westernization of the Japanese diet has led to a fall in the consumption of rice, this traditional staple has remained the mainstay of agriculture thanks to support prices paid to farmers equal to about twice the level of world prices. Because of the administered prices, the Japanese government—like the EEC—has been forced to dispose of the surplus rice produced not only by diverting to livestock feed, but also by subsidized exporting. This has heightened trade tensions between Japan and commercial rice exporting countries, in particular the United States.

Although the United States has recently become more vocal in its criticisms of other countries' agricultural policies, its own farmers are hardly left unprotected from the vicissitudes of the market. The United States has price support programs for a number of farm products—including wool, wheat, cotton, corn, rice, soybeans, sugar, peanuts, tobacco, and dairy products—which frequently result in unwanted surpluses. America also subsidizes its farmers in other ways such as grain storage payments, marketing orders, low-interest loans, and export credit programs.

World agricultural markets are further distorted by the policies of the developing nations. Price controls on domestic sales, export taxes, government import monopolies, selective distribution systems, and mandatory set-aside programs are among the commonly used programs. With many of these programs, however, the effect—contrary to the policies of the industrialized countries—is to discourage agricultural production. Direct price controls are frequently used to maintain consumer prices below the free-market level. But while these policies succeed in keeping retail prices low, they reduce farmers' incentives to produce. One of the economic costs of inadequate domestic food production is a rising import bill—a situation many developing nations can ill afford.

What is often ignored by agricultural policymakers is the vital role that market-determined farm prices play in achieving optimum output, growth, trade, and food-supply security. It is doubtful that the trade ministers attending the General Agreement on Tariffs and Trade meeting in Geneva later this week will take any substantive action toward dismantling the protectionist policies that prevent the price mechanism from doing its job. Indeed, real changes in policy are unlikely to come about until policymakers acknowledge the extent to which they are distorting resource allocation and lowering living standards for their societies as a whole in order to protect the interests of a few favored groups.

Diana J. Rich

Vol. XVII, No. 24
December 6, 1982

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1 12/13/82

The next issue of International Finance will appear on January 3, 1983.

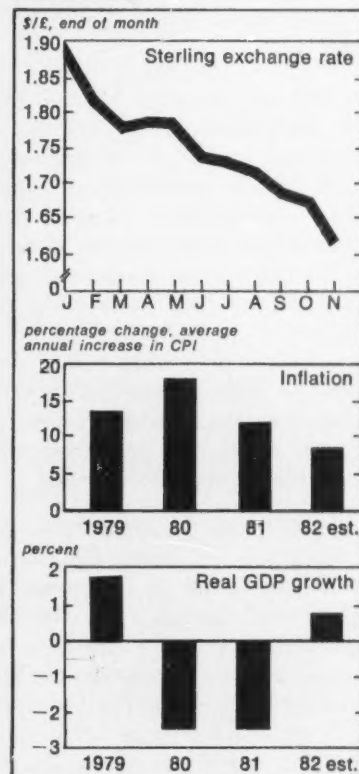
Pressure on the Pound Could Force U.K. Policy Shift

The striking decline of the pound sterling over the past few weeks has given British policymakers reason for pause. Encouraged by 1982's more promising inflation outlook, the Thatcher government had begun to relax some of the tough economic policies that had made life in Britain so unpleasant in recent years. Inflation had finally begun to respond rather dramatically to past policies and was expected to decelerate to around 6% by year-end. Even the money supply was growing within the government's target band. With unemployment still at a postwar high, the Bank of England was nudging interest rates down ahead of—although not in contradiction to—market forces. The government also announced a reduction in employers' contributions to social security and indicated that the budget due in early 1983 would include major personal income-tax cuts.

The unexpected steepness of sterling's November decline, however, may make it difficult to continue on such a course. By the close of business on November 30, the pound had slipped to \$1.62, DM4.01, and a trade-weighted index of 86.7 after finishing October at \$1.68, DM4.29, and an index of 92.5. To be sure, the fall in sterling was welcome to a degree. British industrialists had argued for some time that the pound was so overvalued that they could not compete in world markets. Moreover, the government was growing increasingly concerned about a possible rise in import penetration. Recent official forecasts have suggested that Britain's balance of payments will be back in deficit before the end of 1983. And several government spokesmen—including the chancellor of the exchequer—have indicated a willingness to tolerate some sterling weakness. The speed and size of the November fall, however, has unfortunately brought back worrisome memories of the pound's uncontrollable decline in 1976.

The new measures already instituted suggest that U.K. policies have become relatively less restrictive than those elsewhere in the world; consequently, the risks associated with the holding of sterling have gone up. Nevertheless, it is still difficult to pinpoint any particular reason why the selloff of the pound should have come just now. The government clearly hopes that the small rise in interest rates announced on November 26 will prevent sterling from falling further. For if the decline continues to a point that would threaten renewed inflation, the authorities will be forced to put current policies into reverse and again bolster the interest-rate differential in favor of sterling. However, if interest rates fall elsewhere in the world and if expectations of U.K. inflation do not become too pessimistic, it may still be possible to renew the downward trend in British interest rates.

Selected U.K. economic indicators



Rebound of German economy likely to be delayed until second half of 1983.

Portugal unable to rein in current-account deficit, despite other policy successes.

Marginal progress made in bringing down Brazilian inflation.

Norway's 1983 budget far less conservative than had been expected.

The recession in Germany is deepening. Industrial production in the July-September quarter fell at a seasonally adjusted quarterly rate of 2.8% to reach the lowest level since the end of 1978. Third-quarter industrial order figures also make dismal reading: Foreign order volume fell at a quarterly rate of 4.5%, while domestic order volume declined by 3%. Contrary to earlier official expectations, final demand—both in Germany and abroad—is falling and industrialists now appear to be cutting inventories built up in the first quarter. The seasonally adjusted unemployment rate has risen from 6.7% at the beginning of this year to 8.4% in October and consumer confidence is falling. Against this background, fiscal policy is expected to be tightened somewhat next year, although monetary policy has been eased significantly. Even so, the government's latest forecasts—a 1% decline in real GNP this year and zero growth next year—are looking increasingly optimistic for 1982 and imply a significant recovery in the second half of 1983.

Portugal's economy has yet to show that it has adjusted successfully to current world economic conditions. In 1981, in the face of weak export demand, falling remittances, and lower tourist revenues, the current account of the balance of payments widened to \$2.7 billion—a high 12.4% of GDP. This year, because of the continued weakness of the world economy, export volume is expected to grow only 4%, while remittances and tourist income are again set to fall. Last April the government tightened monetary policy and in June the escudo was devalued by 9.3%. Eventually, these measures should inhibit the currently buoyant import growth, but they will be insufficient to prevent the current-account deficit from reaching \$3 billion—13% of GDP—for the year. The Portuguese government, however, must be credited with some successes: Consumer price inflation has already moderated to a year-on-year rate of 20.7% in September from a peak of 27.1% last March; economic growth this year should exceed the 1.8% achieved in 1981; and the public-sector deficit should fall to about 10% of GDP in 1982 from 11.4% last year.

Brazil's rate of inflation has come down a little as a consequence of a slowing economy, monetary restraints, and lower agricultural prices. For the 12-month period ending in October, the rate of increase in the general price index was almost 96%, down from a rate of 103.4% for the corresponding period last year. The rate of wholesale price inflation dropped even sharper—down to 94% for the similar period of 1982 versus 102% a year earlier. Falling demand, prompted by government efforts to improve Brazil's balance-of-payments position, has helped to bring down the rate of inflation, as have moderating agricultural prices. Moreover, manufacturing production declined by 7.5% in the first eight months of the year. In addition, monetary policy has turned more restrictive, with increased reserve requirements for demand and time deposits. Nevertheless, the pressure on prices from wage adjustments and a higher devaluation rate is still strong. Brazil still has some distance to go before prices can be brought down to reasonable levels, but the effort is being made.

Norway's budget for 1983 is now taking shape. Although the conservative government was elected in the autumn of 1981, there was insufficient time to produce a budget for 1982 and the government was forced to implement the bulk of the programs proposed by their labor predecessors. Thus, the 1983 budget has provided the first test of the conservatives' promise to cut taxes and roll back the influence of the state on Norwegian business. Unfortunately however, oil prices have dropped considerably since the 1981 election and prospects for the rest of industry have been damaged by Sweden's surprise 16% devaluation in October. As a result, the budget contains far fewer radical changes than had been expected. Income taxes have been cut a little and only partially offset by higher sales taxes and higher charges for public services. Government spending, however, will be higher than anticipated and there will be special subsidies

for those industries most affected by the Swedish devaluation, such as the forest products industries, textiles, clothing, and furniture. The budget's forecasts point to a 1% increase in GDP in 1983 after a 1.4% decline in 1982. Private consumption is projected to rise 2.5% this year. Despite the stepped-up activity, the current-account surplus is forecast to increase from 2.75 billion kroner in 1982 to kr 3.65 billion next year. One worrying cloud on the horizon is inflation, which is expected to run at 9.5% in 1983 after 11% this year. These rates are higher than those elsewhere in Europe and may raise doubts about Norway's longer-term trade competitiveness.

On November 25, Japan's ruling Liberal Democratic Party elected Yasuhiro Nakasone to succeed Zenko Suzuki as president of the party and prime minister of Japan. Nakasone, who received support from both the powerful Suzuki and Tanaka factions, most recently was director general of the Administrative Management Agency and hence was in charge of the government's program of administrative reform. Nakasone is expected to advocate a continuation of the general policy of fiscal austerity and has reaffirmed Suzuki's pledge to reconstruct government finances without increasing taxes. However, large revenue shortfalls arising from the slowdown in the Japanese economy may force him to back away from Suzuki's commitment to balance the budget by fiscal 1984. The completion of the election process will allow the Japanese Diet to get on with the passage of the fiscal 1982 supplementary budget—including the fiscal stimulus measures announced in October—which had been temporarily delayed because of the election.

Hong Kong's economic problems continue to grow. Land prices in the colony have plummeted, reflecting reduced inflation expectations and the uncertainty surrounding the colony's future after 1997. As a result, a number of real property companies have failed and it has become virtually impossible for Hong Kong to balance its budget for fiscal 1982/83. Government land sales were accelerated in 1980, producing 35% of Hong Kong's revenues in fiscal 1980/81 and 23% in 1981/82. Unfortunately, however, the drop in land prices has reduced these revenues and this will produce the first public-sector budget deficit since 1974/75. In the first five months of fiscal 1982/83, which began in April, the shortfall amounted to \$HK4.66 billion. This compared with a surplus of \$HK581.8 million in the same period last year. Hong Kong's reserves of \$HK22 billion can easily cover this year's gap, but not a string of such deficits. Thus, Hong Kong Financial Secretary Bremridge has suggested it may be wise to postpone some large public projects, such as a proposed new airport, until government cash flows can be examined more carefully.

The accumulated gross foreign assets of the 13 OPEC nations totalled nearly \$434 billion as of the end of 1981—up sharply from \$368 billion in 1980. Some 77% of last year's total was officially-held, and, of that, about three-quarters were assets accumulated by the governments of Saudi Arabia, Kuwait, the United Arab Emirates, and Qatar. The available data on the deployment of these funds worldwide indicate that only \$377 billion has actually been identified; the balance flowed into unidentified placements such as Swiss fiduciary accounts, unrecorded purchases of gold, and unreported investments. Of the identified placements, \$154 billion was deposited in banks, mainly in the Eurocurrency market. The balance was directed into other, primarily longer-term investments such as purchases of government and corporate securities, direct investments, and loans to other nations and international organizations. The share of bank deposits in identified placements has plummeted in recent years—from 66% in 1979 to 7% last year. With the surpluses of the four Arab Gulf nations that account for the bulk of these funds projected to drop sharply this year, OPEC's gross foreign assets are expected to grow more modestly in 1982 to a maximum of \$445-450 billion by year-end.

*Japan's fiscal austerity
to continue
under Nakasone.*

*Hong Kong budget
victim of
falling land prices.*

*More modest growth
seen for
OPEC foreign assets.*

Money Demand and the Stock Market

The 16% growth rate in M1 from August through October has confounded monetary analysts, most of whom had predicted that money would be far more contained over this period because of the anemic state of the economy. They have attempted to explain the unexpected money bulge by attributing it either to an above-normal precautionary demand for money in a time of high uncertainty or to distortions resulting from such "technical" influences as maturing All-Savers certificates and an inaccurate seasonal adjustment process used by the Federal Reserve. These explanations, however, cannot completely account for the discrepancies. To do so, it is necessary to turn to a consideration that most monetary analysts have tended to overlook: the unusually large volume of stock market transactions that has taken place over the past few months.

Money demand—the public's desire to hold money balances—is determined primarily by two forces. One is the rate of return on relevant substitute assets. This is a measure of income foregone by holding money rather than these assets. When the yield of financial assets rises, the demand for money falls. The second is the services that money provides, especially the facilitation of transactions. The larger the volume of transactions, the greater the amount of money that must be held to perform them. Most forecasting mod-

els of money demand, however, assume that transactions are proportional to gross national product, so that higher GNP levels generate more transactions, which in turn require greater money balances to finance them. But it may not be appropriate to use GNP as a complete measure of transactions.

Since August, the public has appeared to want to hold much more money at the prevailing level of interest rates and GNP than historical experience would suggest. Recent research by the Chase Economics Group suggests that a large portion of this abnormally high money demand can be explained by using a more complete concept than GNP as an estimate of transactions. GNP, after all, does not account for transactions in the financial markets, such as the recent volume surge in the stock and bond markets.

When the stock market boom that began in mid-summer is used to help explain money demand, the surprising growth in M1 is not nearly so surprising. In fact, the simple addition of a variable to capture the value of transactions on the New York Stock Exchange explains nearly all the "excess" money demanded in October—that is, the difference between actual money growth and the amount predicted by standard models. This implies that money may tend to overshoot market predictions in the future during times of surges in stock market volume.

Robert S. Smith

Asia and Oceania Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS				
		6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars
Bangladesh	Balance-of-payments financing constraint will hold economic growth to low level.	June	-15%	11.6*	126	Sept.	170	+ 15%	0.8	404
Burma	Shortfalls in onshore oil production leading to resumption of offshore exploration.	June	-12%	5.8*	159	Oct.	84	- 66%	2.4	49
China, People's Republic	Industrial growth of 7% and a record grain harvest expected in 1982.	June	+10%	260.0	260	June	7,287	+ 91%	4.0	492
Hong Kong	Financial jitters, failures of property companies are fallout from unresolved 1997 problem.	June	+ 7%	24.2	4,695	n. a.	—	—	—	—
India	Government measures spurring private-sector investment boom.	June	+10%	161.4*	236	June	4,279	- 27%	3.8	1,833
Indonesia	Real economic growth forecast at 4% in 1982, 6% in 1983 with 10% inflation.	Dec. '81	+ 3%	81.5	542	Oct.	3,313	- 46%	n. a.	0
Japan	Nakasone expected to continue policies of administrative reform and fiscal austerity.	Sept.	- 1%	1,130.3	9,607	Oct.	22,860	- 19%	2.2	0
Korea	Industrial production has reversed its decline and begun to rise.	Sept.	+ 9%	63.4	1,638	Oct.	2,703	0	1.3	1,222
Malaysia	Budget for 1983 calls for reduced development spending, higher consumption taxes.	May	+ 5%	23.6	1,638	Aug.	3,164	- 17%	2.8	262
Pakistan	Significant deregulation of domestic industry under consideration.	July	+ 4%	30.7*	359	Oct.	999	+ 42%	2.2	1,157
Philippines	Real GDP up 2.9% in first half of 1982 from year ago.	May	- 4%	38.6	780	Oct.	1,708	- 14%	2.7	821
Singapore	Slowdown in world trade causes growth forecasts to be slashed.	Aug.	+ 3%	12.5	5,121	July	7,630†	+ 14%	1.8	0
Sri Lanka	Presidential election results show support for continuation of Jayewardene's open economic policies.	April	+ 8%	4.4	291	Oct.	302	+ 29%	2.2	376
Taiwan	Industrial production up 2.8% in August; year-over-year inflation quite moderate.	May	+ 1%	45.5	2,530	June	7,525	+125%	4.3	0
Thailand	Business depressed by world recession, poor domestic purchasing power owing to low commodity prices.	June	+ 5%	36.1	750	Oct.	1,307	- 6%	1.9	634
Australia	Drought in eastern Australia produces sharp drop in farm income.	Sept.	+13%	158.8	10,686	Oct.	4,976	+198%	2.3	0
New Zealand	Business conditions expected to remain depressed for the next six to nine months.	Sept.	+13%	24.4*	7,858	Oct.	704	+ 41%	1.4	9
Papua New Guinea	Export-led recession continues as commodity prices fail to recover.	June	-19%	2.6**	867	Oct.	396	- 7%	3.7	48

*Fiscal year

**1980 †includes gold holdings

Government Policy Shifting Focus

Dramatic movements in financial markets over the past several weeks indicate that what were once only slightly nagging fears about U.S. policymakers' commitment to reduce budget deficits and fight inflation have become grave doubts. During the past month, the value of the dollar has fallen by more than 10% against the yen and about 6% against the mark. Moreover, the price of gold jumped from under \$390 per troy ounce in early October to \$440 on December 1. And the Euro-dollar yield curve out to one year has turned somewhat steeper. It is still too early to say conclusively that these judgments about the government's resolve are correct. Nevertheless, Congress, the White House, and the Federal Reserve cannot afford to ignore these market warnings.

With unemployment moving toward 11%, it is clear that, politically, the most pressing economic problem is now unemployment rather than inflation or budget deficits. President Reagan recently considered moving July's scheduled reduction in personal income taxes to January, and has proposed a new public works program to create jobs. Congress, in its post-election "lame-duck" session, is considering a number of measures to stimulate the economy. Meanwhile, the Fed continues to permit monetary growth far above target.

Looking back at history, it is not surprising that this shift in emphasis has occurred. Monetary policy for the last 30 years has consisted of alternating periods of ease and relative restraint, while budgetary policy has gen-

erally been expansive. This combination has resulted in the ratcheting upward of inflation.

What is surprising in terms of history is that the Fed held to its restrictive stance as long as it did and that the push for stimulative government spending did not come sooner. Still, policymakers seem hesitant to throw away the gains made in slowing inflation—perhaps because the costs incurred in achieving the advances have been so great. The Fed, for instance, insists that its tolerance of excessive money growth relative to target is only a temporary accommodation of increased demand for liquidity. In addition, current projections that budget deficits will be in the \$150-250 billion range over the next several years appear to be holding some rein on fiscal policy. For example, the administration felt compelled to link its proposed public-works jobs program with its own funding source—an increase in the excise tax on gasoline. And the proposal to advance the income-tax cut met with general disfavor—chiefly because it would have worsened the deficit for fiscal 1983.

Nevertheless, policymakers may yet succumb to political pressures to overstimulate the economy. Congress is considering resolutions that would force the Fed to target interest rates—presumably at a lower level. And jobs bills more comprehensive than the one proposed by the President are also on its calendar. Until the fate of these and other proposals is known, financial-market participants have plenty of cause for concern.

Douglas L. Bendt

CURRENT INFLUENCES ON PAYMENTS		MONEY AND BANKING						COUNTRIES	
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
		latest data	consumer prices	latest data	money supply(M1)				
						December 1, 1982	current monetary conditions		
Imports likely to be severely constrained again this year.	Aug.	+ 7%	June	+ 1%	.0410	—22%	Government has resisted further taka depreciation.	Bangladesh	
Depressed commodity prices, particularly for rice, hurting export earnings.	June	+ 6%	Feb.	+12%	.1260	— 7%	Government remains committed to fixed exchange rate.	Burma	
Import growth accelerating after \$2.4 billion trade surplus in first half.	Dec. '81	+ 3%	June	+12%	.5080	—10%	Investment growth to boost deficits in 1983.	China, People's Republic	
Lower export growth reflects recession in overseas markets.	Sept.	+ 9%	July	+ 6%	.1500	—16%	Weak HK dollar means high interest rates.	Hong Kong	
Trade deficit narrows in first five months of fiscal 1982/83.	Aug.	+ 7%	March	+ 7%	.1030	— 6%	Credit generally restrictive but eased slightly for exports.	India	
Oil prices cut \$.47-\$1.90 per barrel to stimulate sales.	Aug.	+ 8%	May	+30%	.0015	— 6%	Money supply growth expected to be about 25% this year.	Indonesia	
Trade friction with U.S. threatens to heat up again.	Oct.	+ 3%	Sept.	+ 8%	.0040	—14%	Net capital outflow slows with narrowing rate differentials.	Japan	
Imports 6% lower, exports 4% higher, compared to last year.	Oct.	+ 2%	June	+14%	.0014	— 7%	Money grew at 39% annual rate in first two quarters.	Korea	
Export duties reduced, other incentives adopted to encourage exports.	Aug.	+ 5%	Aug.	+11%	.4237	— 5%	Money, credit growth slower this year than in 1981.	Malaysia	
July-Sept. exports in dollars down 15% from year ago.	July	+ 6%	Aug.	+14%	.0800	—22%	Credit remains restrictive; rupee depreciation resumed.	Pakistan	
Payments deficit ballooned to \$747 million in first nine months.	June	+13%	Aug.	— 2%	.1150	— 9%	Term deposits increase strongly.	Philippines	
Foreign currency reserves heading upwards; trade-weighted \$\$ strong.	Sept.	+ 1%	July	+12%	.4560	— 7%	Moderate money growth—4.4% in first half—continues.	Singapore	
Tea prices improve; imports sluggish; remittances strong.	June	+11%	May	+21%	.0473	— 9%	Private-sector credit demand slack.	Sri Lanka	
Trade balance shows strong surplus.	Sept.	+ 2%	July	+19%	.0245	—13%	Year-over-year money growth high but falling.	Taiwan	
Across-the-board 10% import surcharge introduced; some tariffs reduced.	Sept.	+ 4%	June	+ 6%	.0450	— 2%	Interest rates continue to fall.	Thailand	
Inflows of Japanese capital increase reserves, support Australian dollar.	June	+11%	Aug.	— 1%	.9601	—16%	Monetary conditions remain tight.	Australia	
Common market with Australia will stimulate trade across the Tasman Sea.	June	+17%	March	+15%	.7200	—14%	Interest rates down from peaks by 250-500 basis points.	New Zealand	
Copper prices remain extremely depressed, but are expected to improve.	Feb.	+ 5%	Aug.	— 7%	1.2953	—11%	Real interest rates high; M1 fell in first half.	Papua New Guinea	

World Interest Rates

market rates of Dec. 1, 1982; bond yields as of Nov. 26, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	9.00	11.05 December 2	10.00 intervention rate	11.50	9.50	5.00 December 2	18.00 penalty rate 21.00	5.50	4.50 December 2	5.50
Day-to-Day Money	9.004 December 2	15.50	10.75	9.20	13.25	7.05	19.00	6.25	1.75 1-month Euro-Swiss fr. rate	6.75
Treasury Bills 91-day, Middle Rates	8.24	10.80	9.75	12.25	n. a.	n. a.	18.75 87 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.75 finance paper discount basis	11.00 finance paper 15% tax w/h	9.40	11.40 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.60	10.90 15% tax w/h	9.875	11.40 Certified	not traded	8.05	19.90	no market	3.875	no market
Government Bonds Long-term, new and old issues, average yield	10.74	12.60	11.15	8.585	15.125	8.17	20.05	8.68	4.27	8.05
Industrial Bonds prime, long-term, new and old issues, average yield	11.70 Aa Industrials	13.25	12.34	15.096	15.96	8.24	20.06	9.21	5.64	6.82
Bank Short-Term Rate to Best Borrowers (prime rate)	11.50	13.00	11.00	15.50	15.20	11.50	20.75 1/4 qtrly fee on outstg.	8.00	8.50	6.00
Bank Time Deposits 3-month	8.50 Cert. of Dep.	11.05	10.00	12.15	13.25	7.10	11.50	6.875 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	9.875	11.375	10.1875	no market	19.25	7.125	no market	6.5625	3.875	7.50
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8065	1.6325	.02075	.1437	.4057	.0007	.3693	.4732	.00402
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.40 D	.20 D	3.30 D	9.50 D	2.80 P	13.00 D	3.10 P	5.80 P	2.50 P

Eurodollar Deposits (London, interbank, bid) December 2	International Arbitrage (3-month, hedged) + in favor of U.S. dollars	Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under Over 7 yrs. DM Bonds 7 yrs. and under Over 7 yrs.	Gold Price London afternoon fixing
7-day 9.0625	U.S.-U.K. Treasury Bills -1.176	11.25	
1-month 9.375	U.S.-Canada Treasury Bills -0.733	11.50	
3-month 9.75	U.S.-Canada Finance Co. Paper -0.699	7.75	440.25
6-month 10.0625	Eurodollars-U.K. Local Auth. Deposits +0.200	8.00	(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Oct.) 5.1	(Oct.) 10.0	(Oct.) 6.8	(Oct.) 9.3	(Oct.) 4.9	(Oct.) 17.2	(Oct.) 6.2	(Sept.) 3.2
Industrial production*	(Oct.) -8.6	(Aug.) -11.0	(Sept.) -0.1	(Sept.) -3.6	(Sept.) -6.5	(Sept.) -5.9	(June) -2.7	(Aug.) 1.2
Trade balance† (billions of local currency units)	(Oct.) \$5.33	(Sept.) C\$1.75	(Oct.) £0.29	(Oct.) -FF5.80	(Oct.) DM3.99	(Sept.) -Lit.2,179	(Oct.) -SF0.375	(Oct.) ¥540
Money supply (M1)*	(Oct.) 9.0	(Oct.) 5.0	(Aug.) 15.0	(June) 15.0	(Aug.) 3.2	(June) 9.0	(July) 3.5	(Aug.) 5.3
Velocity of money (M1)*	(Sept.) -6.5	(June) 1.5	(March) -5.3	(Dec. '81) 0**	(March) 3.1	(June) 7.6**	n. a.	(June) -1.4
Reserves minus gold (\$ million, change from previous month)	(Oct.) 720	(Oct.) -185	(Oct.) 45	(Sept.) -949	(Oct.) 1,404	(Oct.) -1,226	(Oct.) -301	(Oct.) -1,149

* Percent change from 12 months earlier.

**based on GDP

† Figures are only for the month indicated.

Slower Growth for the Euromarkets

Eurocurrency bank lending appears to be leveling off. Data from the Bank for International Settlements show that net lending—that is, excluding most interbank positions—picked up somewhat in the second quarter from the first (see table, page 8). But net-lending growth in the first half of the year was still well below that of the second half of 1981. Furthermore, preliminary evidence suggests that net Eurocurrency claims may well have fallen in the third quarter.

Any analysis of Euromarket activity must take into account the high degree of integration that exists between the Euromarkets and domestic money markets—particularly in the dollar sector. This is demonstrated by the narrow—but variable—“arbitrage tunnel” between Euro and domestic interest rates on deposits of equal maturity and by the variability of U.S. banks’ net positions vis-à-vis their foreign branches. The arbitrage tunnel is the band within which the interest-rate differential between domestic and Eurodollar deposits can fluctuate before arbitrage becomes profitable. The fact that there have been periods when the differential remained outside the tunnel simply confirms that the substitutability between domestic and offshore deposits, while close, is less than perfect.

This relation between Euro and domestic markets suggests that two principal forces underlie the growth of the Euromarkets: The first is the size of total credit expansion—domestic and foreign—by the major developed economies. The second is the distribution of deposit and credit flows between domestic and offshore markets. Credit expansion is determined primarily by the monetary policies of the major industrial countries, even though the impact of a change in policy on overall credit growth is neither straightforward nor immediate. The distribution of deposit and credit flows between domestic and offshore markets, on the other hand, is influenced by a number of economic variables. These include risk perceptions, market depth at the preferred maturities, economies of scale in transactions costs, the costs of gathering and disseminating information on creditworthiness, differences in the regulatory environments of domestic and offshore institutions, and convenience factors such as time zones.

The advantages of the Euromarkets in many of these areas led to their rapid growth in the 1960s and 1970s, and to their institutionalized primacy as vehicles for both international capital flows and the short-term financing of international trade. The Euromarkets have also become the preferred habitat for many official holders of short-term financial assets. As a result, an additional set of influences on the distribution of credit flows has emerged: imbalances in the world’s (gross) balances of international pay-

ments, the relative asset and maturity preferences of capital-exporting countries, and the volume of international trade and gross capital flows. The most obvious example of balance-of-payments flows and asset preferences was the recycling—largely through the Euromarkets—of the OPEC current-account surpluses.

Behind the recent slowdown

This framework can be used to explain the recent slowdown in the growth of the Euromarkets. Monetary policies were tightened in the world’s major economies following the second oil-price shock. The impact of such a policy shift on narrowly defined money—currency and demand deposits—may occur fairly quickly (although even this effect was almost certainly mitigated in the current cycle by an uncertainty-related rise in liquidity preference). But the effect on the growth of national and international credit is not felt until after some delay. Indeed, in the short run, a tightening of monetary policy by any means other than direct credit control frequently raises credit growth, as companies seek to finance unintended inventory build-ups or higher interest charges. After a while, economic activity and inflation decline and credit growth slows. This stage in the cycle was reached by 1982.

Furthermore, by mid-1982 there appeared to have been a reassessment of international financial risks following the failure of several small banks and the well-publicized financial difficulties of a number of large industrial concerns. This culminated in the so-called “flight to quality” seen in the late summer. This movement then led not only to a widening of the gap between yields on private (including banks’) liabilities and those on government liabilities, but also to a greater dispersion of yields within different groups of private-sector liabilities.

In general, the extent to which credit flows respond to these altered risk perceptions depends on the interest sensitivity of loan demand. Hence, the recent renewed decline of these “deposit risk spreads” could signify either an abatement of the concern with risk or a highly interest-responsive demand for loans. However, in the absence of offsetting forces, a flight to quality would reduce the growth of bank credits, although it is uncertain by how much.

In addition, several considerations specific to the Euromarkets have come into play over the past several months:

- First, heightened risk premiums appear to have been attached to Eurodollar deposits. Yields have been above the arbitrage tunnel since early 1981. And they rose sharply in the wake of the failure of the Banco Ambrosiano in June and subsequent market

Slower Growth for the Euromarkets *(continued from page 7)*

doubts about the correct interpretation of the Basel Concordat.

- Second, the growth in assets whose preferred habitat had been the Euromarket slowed sharply; the combined current-account surpluses of Saudi Arabia, Kuwait, and the United Arab Emirates declined from some \$68 billion in 1981 to an estimated \$20 billion this year.

- Third, a rise in the perceived risk of loans to developing countries—the result of the process of disinflation in the industrialized countries—spurred a sharp reduction in such lending. This had a disproportionately large effect on the Euromarkets, since these are now the principal vehicles for such international lending.

- Finally, the decline in the growth of international trade—and more recently in the actual level of trade volumes—may also have contributed to a weakening of Euromarket growth. However, this may well have been offset by an increase in gross capital flows among developed countries in response to greater interest and exchange-rate volatility.

The Euromarket outlook

For 1983, a further reduction in Euromarket growth seems likely. For one thing, most of the forces affecting 1982 will still be at work. And although there is some evidence that monetary policy is being relaxed in the world's major financial centers, these policy shifts will not have an immediate impact on credit growth; delays work on the upswing of the economic cycle as well as on the downswing. Moreover, any recovery in economic activity in 1983 will at best be sluggish, and inflation will fall somewhat further. Consequently, credit flows in the industrial world are likely to decelerate over the near term.

The developing countries will continue to have difficulties in attracting private capital flows—albeit

less so than in the second half of 1982—and this effect alone will dampen Euromarket growth. Furthermore, since official flows are unlikely to compensate for the reduction in private capital flows, the developing countries with current-account deficits will have no choice but to cut back their imports, even if their debt-service positions are eased by lower interest rates. This will exert further downward pressure on world trade volume—both directly and via multiplier effects—and thus on the need for trade financing through the Euromarkets.

Continued net inflows into the Eurocurrency markets from such sources as the "low-absorbing" OPEC countries must also be questioned. This is in part because the surplus available for investment is shrinking and in part because—in an environment of falling interest rates—asset-maturity preferences may further shift away from the short-term Eurodeposits toward longer-term financial instruments.

Other forces will offset these effects to a degree, however, the summer's risk premiums of Eurodeposits over their domestic counterparts are likely to fade. Central banks have shown an awareness of the need to underpin confidence in the Euromarkets, debt reschedulings have been orderly even if protracted, and the market has survived the Ambrosiano affair as it survived the 1974 failure of the Herstatt bank.

Over the long run, the continued real growth of the Euromarkets is a function of world trade and freedom of capital movements. And, ironically, it is inversely related to the degree of harmonization in monetary policy among countries. Based on these criteria, the markets' real rate of growth seems set to expand again in the mid-1980s. This will depend, however, on fulfillment of the related conditions of a world recovery and a reversal of the current movement towards protectionism.

George de Nemeskeri-Kiss
Chase London

Quarterly Euromarket Report

(\$ billion, end of period)

Total Market Size	IIIQ/81	IVQ/81	IQ/82	IIQ/82	1979	1980	1981
Gross Size (Claims)	1,424.0	1,550.2	1,559.1	1,570.0	1,111.0	1,321.9	1,550.2
Net Size (Claims)	875.0	945.0	945.0	965.0	665.0	810.0	945.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	293.1	303.2	303.8	309.4	269.7	287.5	303.2
Liabilities to Private							
Nonbank Foreigners	90.6	94.3	97.0	105.5	65.9	75.0	94.3
Total Claims on Foreigners	422.2	445.7	457.0	469.6	324.2	385.4	445.7
Claims on Foreign Public Borrowers	55.0	59.4	60.0	65.2	42.0	48.9	59.4
Claims on Foreign Private							
Nonbank Borrowers	148.7	161.3	162.8	165.2	117.8	139.9	161.3

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches. Source: Chase Manhattan Bank estimates based on BIS and national data sources.



International Finance

Vol. XVIII, No. 1
January 3, 1983

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

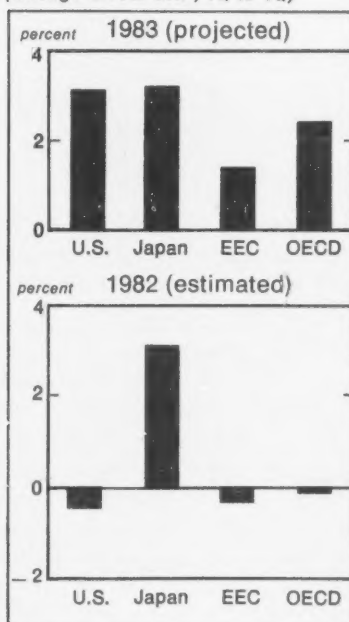
The World Economy in 1983—Progress, but Not Without Pain

The prospects for the world economy in the coming year are decidedly mixed. Although the short-run indicators in most industrialized economies are discouraging, a moderate recovery of aggregate OECD output in the course of the year is likely. The United States should show the quickest turnaround—perhaps as early as late winter or early spring—and will record the hardest rebound in growth among the major industrialized countries. The outlook for the European economies is less optimistic, with recovery likely to be delayed until the second half of the year and slow to develop momentum. The prospects for growth in the developing countries differ widely by region. The growth performance of most Asian economies will not vary significantly from last year, but the outlook for many African and Latin American economies has taken a turn for the worse as a result of the dramatic change in the climate of international lending.

The sharp decline in imports by the developing countries is one major element slowing recovery in the industrialized countries—reducing potential OECD growth this year by as much as one percentage point. A second negative force is the continuing global weakness in capital investment. Prospective improvements in capacity utilization and business profits are not likely to be sufficient to reverse the decline of investment in plant and equipment before 1984. Furthermore, concern that economic recovery will not bring about significantly lower government borrowing requirements—given current fiscal policies—may constrain the reduction of long-term interest rates.

Nonetheless, there are reasons for some optimism. Most important, monetary policy in the key industrialized countries has become relatively more expansionary. Interest rates have fallen sharply since mid-1982 and should continue to decline. Household balance sheets have improved markedly, and consumer spending should make strong gains by midyear, particularly in the United States. Residential construction in the major OECD economies appears likely to show significant growth, and a classic inventory rebuilding cycle is in the offing. Finally, the earlier fears of a major upset in the international financial system have been calmed by successful cooperation between official institutions and the international banking community in putting together refunding packages for those developing countries with severe liquidity problems. The global economy will show only moderate recovery in 1983, but its growth performance should be noticeably better than the sorry record of the year just past.

Projected economic growth in 1983 compared with 1982
(Change in real GNP, 4Q to 4Q)



WESTERN EUROPE

The hesitant recovery that was signaled in Western Europe at the start 1982 failed to materialize. The initial recovery in stock-building was followed by a further downturn in final demand as fiscal policies were tightened, consumer and investor confidence waned, and demand outside Europe continued to decline. By the third quarter, GNP in most countries was falling again. More recently, monetary policies have been eased, but interest rates remain high relative to Europe's declining inflation rates. Meanwhile, fiscal policy has been tightened yet again. Hopes for a 1983 recovery are now pinned on a further fall in interest rates and an economic upturn in the United States and Japan. These suggest, at best, a weak revival in the latter half of 1983—but the risks remain on the downside.

In the **United Kingdom**, inflation has fallen even faster than the most optimistic projections suggested; still, domestic output remains stubbornly low. With 1983 likely to see an election, the markets expect a moderately expansionary budget that will generate some 1.5% growth in GDP while keeping the average rate of inflation below 7%.

Short-term growth prospects in **France** are rather poor following the tightening of economic policy in mid-1982. It seems unlikely that real GDP will increase by more than 1% this year, about the same as 1982. The impact of price and wage controls will lower the average inflation rate to 11% from 12%. Weak domestic demand, coupled with some pickup in exports, may reduce the current-account deficit to FF 55 billion from FF 70 billion last year.

Switzerland's domestic demand is now very weak, in line with falling foreign sales. Preliminary estimates of 1982 real GDP suggest a decline of as much as 1.5%, with prospects of, at best, zero growth in 1983. Inflation will average around 4.5% and the current account will register a strong surplus of close to SF 10 billion.

Fiscal policy in **West Germany** has been tightened despite an election scheduled for March, and real wages look set to fall for the third consecutive year. Even with a second half recovery, real GNP is expected to show, at best, no growth for 1983 overall after about a 1% decline in 1982. Inflation should slow to some 3.5%—or less if the U.S. dollar weakens early in 1983—and the current account should continue in small surplus. The picture for the **Benelux** countries is much the same.

Italy continues to suffer from high inflation and a large balance-of-payments deficit. Hopes for an export-led recovery have not yet faded, but even so, real growth of less than 1% is likely after a flat performance in 1982. Inflation is likely to exceed the government's target of 13%, while the current-account deficit is forecast to narrow to some \$5 billion as the terms of trade improve.

The **Scandinavian** economies are expected to grow a little faster than the European average, but at the cost of continuing inflationary pressures, which were increased by the round of devaluations last October.

Canada experienced its worst economic performance in recent history in 1982, with a real GNP decline of 4.5%-5% accompanied by inflation averaging more than 10%. Expectations are that 1983 will bring a small gain in real growth and a rate of price increase of about 8%.

In the Latin American-Caribbean area, 1982 was a year of falling output and big debt refinancings. Preliminary estimates of last year's regional GDP growth show a decline of at least 1%, making 1982 the worst year since these data have been compiled. The need for external debt amortizations and refinancings will have a continued pervasive influence on the region in 1983. The IMF, in conjunction with other international institutions and supported by the commercial banks, is assuming an increasingly predominant role and is likely to have a total of \$16 billion of its own financial arrangements covering some 15 Latin American-Caribbean countries this year. Given the restrictive policies that the debt difficulties will require, plus continued lackluster world economic growth, further economic decline in the region in 1983 is inevitable—probably in the neighborhood of 2%.

Brazil's economy showed practically no growth last year. And in view of the demand restrictions accepted under its agreement with the IMF, little or no growth is expected in 1983. **Mexico** has also announced tough restraint measures that are likely to reverse 1982's 2% increase in GDP to as much as a 4% decline in 1983. Last year was **Argentina's** second

WESTERN HEMISPHERE

year of declining economic activity. However, there is some possibility of a small recovery in real GDP in 1983—even with an IMF stabilization program.

Among the Andean economies, **Venezuela**, **Colombia**, **Ecuador**, and **Peru** recorded extremely low levels of activity in 1982, while **Chile** suffered a huge 13% drop in output. The outlook for 1983 anticipates continued low growth—or even declines—in GDP, as all of these countries face policy-induced demand restraints and weak commodity prices. **Uruguay's** economy declined sharply in 1982 but a slight recovery could take place this year, while **Paraguay's** previous experience of high GDP growth is changing to a smaller—but still positive—economic advance in 1983.

For Central America, political and economic difficulties will continue to affect all countries, offering little hope that the low growth or declines of the past year will improve much. **Costa Rica** could show some strengthening under an IMF stabilization plan, however. **Panama** has managed to avoid many of the problems of Central America, but its growth has been adversely affected by the decline in international trade.

The Caribbean economies are all facing subdued conditions and rising concern over international earnings from commodities or tourism. **Trinidad and Tobago** will experience slower growth because of world oil price weakness. **Jamaica's** advance will be limited by the soft demand for bauxite. The **Dominican Republic** is undertaking an IMF program to finance its payments deficits, while the **Bahamas** has had to impose budgetary restrictions to offset lower revenues from tourism. **Puerto Rico** may pull out of its deep 1982 depression as the U.S. economy shows improvement. Even **Cuba** has not been spared the region's difficulties; its sugar-based economy will be under serious debt constraints in 1983.

ASIA-OCEANIA

In **Japan**, consumer spending—the main source of strength last year—will increase more moderately in 1983 as the public-sector wage freeze holds down private-sector wages. Consequently, any acceleration in real growth from the estimated 2.8% in 1982 will depend primarily on a pickup in external demand. The weak yen and recovery in the world economy suggest a boost in export sales. But high inventories of Japanese goods abroad and the rising tide of U.S. and European trade restrictions will moderate export growth. Thus, Japan's real growth is expected to increase only slightly to about 3%-3.5%, and the current-account surplus is projected to widen to \$9-10 billion in 1983 from around \$7.5 billion in 1982. Inflation is likely to accelerate to 3.5% from 3% last year, owing to expansionary monetary policy.

Prospects for Asia's newly industrialized countries (NICs) in 1983 depend on recovery in their OECD markets. If the turnaround in the OECD economies is delayed until the second half of the year, growth in the NICs will remain sluggish for most if not all of 1983. **South Korea's** growth rate is expected to be the highest at around 6%, while economic growth for **Taiwan** and **Singapore** should be in the 4%-5% range. Although **Hong Kong's** overall outlook remains clouded by the uncertainty over the China lease, exports should recover rapidly.

The Philippines has begun to benefit from lower interest rates on its external debt and from a slight recovery in commodity prices. If these trends continue, GDP growth could climb back to the 4%-5% range. **Thailand's** payments deficit has been declining, and while business activity is sluggish, the effects of the recession are moderate. As a result, 1983 GDP growth should be around 6%. **Malaysia's** current-account deficit for 1982 is estimated to have been over \$3.5 billion, and GDP growth dropped to about 4%. This year is likely to be only slightly better, with growth around 5% and a current-account deficit just under \$3 billion. **Indonesia** has suffered a sharp payments reversal, with a current-account deficit on the order of \$7 billion expected for fiscal 1982-83 owing to disappointing oil revenues and a severe decline in commodity earnings. Because of this, some large capital projects may have to be cut back. Better balance in industrial growth and continuing agricultural success will sustain **China's** 1983 growth at 4.5%. Furthermore, imports should increase by more than 15%, given strong foreign-exchange reserves.

Australia's high wage structure and the low demand for its commodities continue to depress exports. Real output in fiscal 1982-83 will decline, and only a slow 1983-84 recovery is forecast. **New Zealand's** real GDP will rise 2% in the fiscal year beginning April 1, after falling more than 1% in the current year.

Depressed world demand for oil last year touched off a 17% decline in OPEC oil output and a significant drop in the average effective price. As a result, the OPEC current account swung to a deficit estimated at \$5-10 billion from a surplus of \$60 billion in 1981. Oil demand is projected to expand this year, but not strongly. Consequently, even if the oil price structure does not crack, the OPEC current account will be just balanced, at best, in 1983.

Saudi Arabia's oil output will remain depressed this year, so that a substantial budget deficit may result even if development outlay is curtailed. Economic activity in Kuwait will be constrained by the effects of the recent stock market difficulties, although corrective measures appear to have averted a major crisis. In the UAE and Qatar public-sector outlays will be restrained this year, but less so in Oman where more external borrowing is planned. Development expenditures in Tunisia will accelerate and more will be financed externally. Morocco's financial deficits will narrow from recent record levels, but Egypt's deficits will widen with the slowdown in the growth of export earnings; both countries will remain heavily dependent on external aid. Iran, by means of heavy price discounting, has bolstered oil exports and now faces a comfortable external financial position. In contrast, the enforced closure of Iraq's Arab Gulf oil-export outlets has caused a severe revenue loss, forcing cut-backs in development spending. Algeria's balance of payments has remained sound because of higher LNG and condensate sales and continued conservative spending. Libya has expanded oil exports rapidly by price cutting and is now beginning to reduce its accrued payments arrears. And in Bahrain, activity remains brisk thanks to new industrial and infrastructural projects. Meanwhile, Jordan has begun to suffer from a slowdown in aid payments. In Israel, inflation may average 130% in 1983 barring any new, well-defined policy initiatives.

Sub-Saharan Africa in 1982 saw a continuation of the declining trends in export revenues and agricultural output, coupled with rising external indebtedness. The resulting deterioration in debt-servicing capacity set in motion debt-rescheduling procedures in a number of countries—some of which had defaulted on previously rescheduled debt. Nigeria has had to retrench its ambitious development plans, partly as a result of lower oil revenues. South Africa may have passed the low point in its balance of payments—as gold prices have rebounded—but continues to suffer from economic stagnation. Oil exploration and development are proceeding in Ivory Coast, Cameroon, Gabon, the Congo, and Angola, with injections of much-needed foreign investment funds. However, for the majority of these countries, 1983 will bring recession-induced austerity measures, currency devaluations, and shrinking import volumes.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, mil-lions of dollars	current influences on payments	12-month changes		exchange rate in U.S. dollars December 29, 1982	change from year earlier	current monetary conditions			
												latest data	consumer prices				latest data		money supply(M1)
Argentina	Agriculture and trade leading economic recovery but inflation is at a 200% annual rate.	June	— 7%	128.0	\$4,547	Aug.	2,681	— 29%	3.3	0	Agreement reached on IMF program of \$2 billion to help payments position.	Nov.	+206%	June	+140%	.000024	—83%	Interest rates rising.	Argentina
Bahamas	Increase in auto and gasoline taxes plus higher im-port duties imposed for budget needs.	June	— 1%	1.3	5,200	Oct.	126	— 1%	3.6	0	Debt-service payments decline.	Aug.	+ 6%	Aug.	+ 7%	Par	—	Bank liquidity rising.	Bahamas
Brazil	Real GDP expected to show zero growth in 1982 as result of industrial slowdown.	Oct.	—12%	284.8	3,343	July	6,160	+ 15%	3.5	0	IMF program for \$4.8 billion approved.	Nov.	+ 95%	Oct.	+ 70%	.0042	—47%	Banks offering higher CD rates.	Brazil
Chile	Agriculture hard hit by economic recession and large debts.	Aug.	— 1%	35.3	3,126	Oct.	1,966	— 41%	5.9	11	Trade in surplus as imports decline.	Oct.	+ 16%	July	— 17%	.0130	—50%	Money supply falls as foreign reserves drop.	Chile
Colombia	Real GDP growth slows to 1.5% in 1982 as industry and exports decline.	Sept.	— 6%	37.3	1,399	Oct.	3,743	— 17%	8.3	0	Reserves drop as services income falls.	Sept.	+ 24%	Sept.	+ 25%	.0145	—28%	Government attempts to reduce interest rates.	Colombia
Costa Rica	Real GDP decline of 6% estimated for 1982; unem-ployment rising.	Aug.	—16%	5.0	2,200	Oct.	207	+105%	2.9	90	Imports reduced because of debt prob-lems.	Aug.	+103%	June	+ 67%	.0245	—59%	Interest rates increased to cap-ture savings.	Costa Rica
Dominican Rep.	Tax increase effort being introduced as part of IMF program.	Nov.	—30%	7.3	1,314	Oct.	53	— 74%	0.5	68	Government requests refinancing of ar-rears.	June	+ 8%	Aug.	+ 15%	Par	—	Central bank to limit credit growth.	Dominican Rep.
Ecuador	Real GDP growth down to 1.5% or less in 1982 owing to oil export decline.	July	— 6%	12.3	1,429	Aug.	365	— 47%	2.0	0	New restrictions placed on imports.	Aug.	+ 15%	May	+ 22%	.0302	— 3%	Credit to public sector reduced.	Ecuador
El Salvador	Foreign exchange shortage and low commodity prices cause GDP decline.	April	— 4%	3.5	701	Oct.	106	+ 49%	1.4	95	Trade deficit grows as exports decline.	June	+ 12%	July	+ 5%	.4032	0	Special government credit ex-tended to business.	El Salvador
Jamaica	Economic growth slowing because of declining baux-ite sales.	July	—29%	2.8	1,271	Sept.	116	+ 45%	1.0	574	USSR to purchase bauxite on seven-year basis.	July	+ 6%	July	+ 24%	.5600	— 2%	Large rise in domestic credit.	Jamaica
Mexico	Fiscal deficit to be cut to 8.5% of GDP in 1983 from 1982's 16.5%.	July	0	238.7	3,303	Feb.	2,243	— 28%	1.6	0	Peso allowed to float.	Oct.	+ 79%	Aug.	+ 42%	.0105	—73%	Interest rates raised as inflation rises.	Mexico
Panama	Government making greater effort to cut fiscal deficit through spending restraint.	June	—17%	3.8	2,027	Aug.	82	— 30%	0.6	77	Sugar exports down sharply.	Sept.	+ 5%	May	+ 8%	Par	—	Credit to government declines.	Panama
Paraguay	Depressed commodity prices and drop in construc-tion activity slow economy.	Aug.	+40%	5.4	1,653	Oct.	697	— 10%	13.2	0	Exports to Brazil recently increased.	Feb.	+ 6%	Feb.	— 4%	.0079**	— 1%	Central bank credit reduced.	Paraguay
Peru	Public spending down, consumption cut by inflation; economy in recession.	June	+32%	21.0	1,160	June	1,444	+ 19%	5.4	571	Faster devaluation helps exports.	July	+ 62%	April	+ 46%	.0011	—52%	Credit to private sector in-creased.	Peru
Puerto Rico	Unemployment rate down slightly from 24% high of July-August.	Sept.	+ 4%	11.7	3,658	Oct.	11,203*	— 2%	16.0	—	Record trade surplus estimated for 1982.	Sept.	+ 1%	Oct.	+ 4%	Par	—	Loan-to-deposit ratio increases.	Puerto Rico
Trinidad & Tobago	Decline in oil and sugar production offset by expan-sionary fiscal policy.	June	—17%	7.1	5,930	Oct.	3,165	— 2%	10.8	0	Lower oil earnings produces trade deficit.	Aug.	+ 12%	July	+ 35%	.4167	0	Banks restraining credit growth.	Trinidad & Tobago
Uruguay	Foreign-exchange rate devalued in effort to aid ex-port industries and tourism.	Aug.	—29%	10.9	3,711	Aug.	168	— 61%	1.7	92	Export rebates eliminated.	March	+ 22%	June	— 6%	.0340	—62%	Domestic credit is scarce.	Uruguay
Venezuela	Lower oil export earnings and cuts in public spend-ing depress economy.	June	—19%	69.4	4,454	Oct.	6,875	— 11%	6.4	0	Import controls put on 355 products.	Sept.	+ 9%	July	+ 4%	.2329	0	Central bank expanding credit facilities.	Venezuela

*Commercial bank deposits

**imports and exports

The modest recovery in OECD growth projected for 1983 and rising confidence that the recovery will strengthen in 1984 should sustain an increase in most commodity prices. However, the price rebound is projected to be limited. Continuing weakness in the machinery sector, buffers existing in present inventory levels and idle capacity, the moderation of inflation expectations, and continuing positive real interest rates will all act to moderate price increases among the industrial commodities. And for most agricultural commodities, the combination of increased capacity, higher yields, and stagnant demand have boosted stocks and will constrain any rise in prices in 1983.

The largest gains in commodity prices this year are expected in metals and minerals that suffered sharp declines in 1982. Copper prices are projected to rebound to around 80¢ per pound on average in 1983 from around 68¢ last year. The prices of other metals such as nickel and zinc will recover more slowly, since a strengthening of demand for these commodities depends critically on an upturn in OECD capital investment.

The last four months of 1982 saw a significant recovery in the prices of precious metals. Gold prices, triggered by fears over the possibility of major international financial disruptions, climbed to over \$450 per ounce. Prices could rise further in 1983 but are just as likely to fall, given the foreign-exchange requirements of the principal gold-producing nations. Silver prices firmed markedly toward year-end 1982 and should average around \$13 per ounce in 1983.

For wheat, a record U.S. harvest and good production results elsewhere—except in Australia—pushed market prices to a four-year low. A modest recovery in prices is possible in 1983 given a decline in North American production—partly stemming from the introduction of a new U.S. acreage reduction program. Continuing good harvests for U.S. corn and a partial recovery in Soviet coarse grain production have seriously depressed corn prices and reduced U.S. exports. Growth in consumption of coarse grains will be insufficient to reduce world stocks, so any price recovery will be modest. Despite a record harvest in China, world rice production in 1982-83 will decline because of rainfall problems in South Asia.

The production surge of recent years in oilseeds and related products is expected to continue, with the most rapid growth being in palm oil and rapeseed. A modest turnaround in soybean prices is forecast for 1983, but the prices for other vegetable oils are likely to decline by 3%-5%. Coffee prices are projected to fall in 1983, while a rebound in cocoa prices of perhaps 5%-7% appears likely. Sugar prices are expected to remain about 6¢-8¢ per pound on average in 1983, owing to price-support programs in the OECD and the competition from sweetener substitutes. Higher demand and projected declines in stocks should boost cotton prices by around 5% in 1983.

World Interest Rates

market rates of Dec. 29, 1982; bond yields as of Dec. 24, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	10.26	10.00 intervention rate	11.50	9.50	5.00	18.00 penalty rate 21.00	5.00	4.50	5.50
Day-to-Day Money	9.00	12.50	10.375	9.15	12.875	6.00	19.00	5.375	1.25 1-month Euro-Swiss fr. rate	6.875
Treasury Bills 91-day, Middle Rates	8.10	9.95	9.875	12.25	n. a.	n. a.	18.10 90 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	10.15 finance paper 15% tax w/h	9.706	11.40 Certified	12.9375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.60	10.05 15% tax w/h	9.875	11.40 Certified	not traded	6.90	19.90	no market	3.625	no market
Government Bonds Long-term, new and old issues, average yield	10.69	12.00	10.82	8.54	14.71	7.82	19.45	8.04	4.27	7.91
Industrial Bonds prime, long-term, new and old issues, average yield	11.85 As Industrials	12.75	12.47	13.72	15.88	7.98	19.85	8.74	5.66	7.20
Bank Short-Term Rate to Best Borrowers (prime rate)	11.00	12.50	11.25	15.50	14.80	9.00	20.75 1/4 qtrly fee on outstg.	7.50	8.50	6.00
Bank Time Deposits 3-month	8.375 Cert. of Dep.	8.50	10.375	12.10	12.875	6.35	11.50	5.50 large deposits	3.00 residents only	3.75
Eurocurrencies 3-month, asked	9.4375	10.75	10.75	no market	25.00	6.1875	no market	5.375	3.50	7.00
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8063	1.6212	.021906	.1489	.4216	.000734	.3806	.4999	.004296
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.191 D	1.209 D	5.186 D	15.581 D	3.321 P	16.894 D	4.204 P	5.681 P	2.328 P
Eurodollar Deposits (London, interbank, bid) December 29	7-day 10.125 1-month 9.625 3-month 9.375 6-month 9.6875	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills -0.431 U.S.-Canada Treasury Bills -0.285 U.S.-Canada Finance Co. Paper -0.320 Eurodollars-U.K. Local Auth. Deposits +0.084					Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 11.50 Over 7 yrs. 11.75 DM Bonds 7 yrs. and under 7.75 Over 7 yrs. 8.50	Gold Price London afternoon fixing 460.50 (per fine ounce)		

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Nov.) 4.6	(Nov.) 9.8	(Nov.) 6.3	(Nov.) 9.4	(Nov.) 4.7	(Nov.) 16.7	(Nov.) 5.8	(Nov.) 2.3
Industrial production*	(Nov.) -7.3	(Aug.) -11.0	(Oct.) -0.5	(Oct.) -2.3	(Oct.) -6.5	(Oct.) -5.4	(June) -0.7	(Nov.) 2.3
Trade balance† (billions of local currency units)	(Nov.) -\$4.09	(Oct.) C\$1.68	(Nov.) £0.47	(Nov.) -FF6.90	(Nov.) DM4.85	(Oct.) -Lit.1,120	(Nov.) -SF0.44	(Nov.) ¥75
Money supply (M1)*	(Nov.) 8.8	(Oct.) 5.0	(Sept.) 14.4	(July) 14.7	(Sept.) 6.1	(July) 11.0	(Aug.) 5.4	(Aug.) 5.2
Velocity of money (M1)*	(Sept.) -6.5	(June) 1.5	(March) -5.3	(March)** 0.4	(June) 0	(June)** 7.6	n. a.	(June) -1.4
Reserves minus gold (\$ million, change from previous month)	(Oct.) 720	(Oct.) -185	(Oct.) 45	(Sept.) -949	(Oct.) 1,404	(Oct.) -1,226	(Oct.) -301	(Oct.) -1,149

* Percent change from 12 months earlier.

** based on GDP.

† Figures are only for the month indicated.

The U.S. Economic Outlook

The economic recession that began in August 1981 apparently continued throughout 1982, making it the longest of the eight recessions since World War II. Official statistics are not yet available, but total activity (real GNP) appears to have declined by about 1% between the fourth quarter of 1981 and the fourth quarter of 1982. While the recession may come to an end in early 1983, the pace of recovery is likely to be modest for the first few months. The unemployment rate—which was 8.5% in January 1982—may exceed 11% for a while before turning down later in the year.

Although the recession is continuing, some of the ingredients for recovery are now in place. The rate of price inflation is 5% or less—well under half the rate of just two years ago. The slowing of inflation, in turn, is one of the forces that have permitted interest rates to fall sharply (see next section). Before recovery can begin, however, it will be necessary for businesses to get inventories down from the excessive levels they reached last summer. Substantial cuts in industrial production in the latter part of 1982 indicate that this process is well under way. Once it is completed, probably by spring, employment and income should increase fast enough to stimulate consumer buying and thus support a general economic expansion.

Thanks to the decline of interest rates, one sector—residential construction—has already turned up. The last two years were the worst for housing construction in more than three decades. In 1981, construction was started on fewer than 1.1 million units of housing; as recently as 1977 and 1978, housing starts totaled about 2 million a year. The situation began to improve late last fall, and housing starts for 1982 are now estimated at 1.3-1.4 million units.

Aside from military expenditures, activity in other major sectors remains lackluster, at best. Consumer spending (about two-thirds of U.S. GNP) has been close to flat in real terms. Sales of such durable goods as automobiles and household appliances have been especially weak. Total auto sales last year, at less than 8 million units, were the lowest since 1964; sales of domestically produced cars were lower than in all but three of the years since the early 1950s. Automobile sales are generally expected to improve by 10%-15% in 1983.

The outlook for other sectors of the economy is less promising, especially for the first half of the year. Capital investment by business held up quite well during the early months of the recession, but has since turned sharply down. It fell at annual rates exceeding 10% in real terms during the second and third quarters of 1982. Orders, backlogs, and investment surveys all indicate that the decline will continue well into 1983, resulting from a squeeze on corporate liquidity

and the lowest industrial operating rates since measurement began in the late 1940s. Investment is expected to be off by about 6% in real terms this year, following a drop of 4% in 1982. It should level off in the second half, but material improvement is unlikely before 1984. The other notably weak sector is foreign trade; it is discussed in detail on the next page.

The weakness in investment and foreign trade virtually assures that the pace of economic recovery in 1983 will be muted during its early stages, but the drag they exert on the economy should diminish late in the year. Total growth in real GNP may amount to about 2½% for 1983, measured fourth-quarter to fourth-quarter. Year over year, that would mean a gain of about 1.3%. The rate of price inflation is expected to show modest further improvement this year.

Lower interest rates likely

In general, interest rates will reach lower average levels this year than they did in 1982. This pattern, which will be most pronounced among short maturities, will result primarily from the more tame behavior of the monetary aggregates. To be sure, M1 will continue to be distorted by the influence of the new bank money-market deposit accounts, particularly early in the year. However, because both M1 and M2 finished 1982 above the top of their target ranges, next year's target growth paths—again probably 2½%-5½% for M1 and 6%-9% for M2—will apply to a higher base level. After this stock adjustment, money can resume its growth rate from the higher base. Moreover, because of the relatively weak economy and further improvement in inflation, the demand for money should be fairly soft, at least through the first half of the year.

Of course, interest-rate declines, precautionary buildups, or technical influences could spur periods of strong monetary growth. This would then leave the Federal Reserve with the difficult choice of either tightening prematurely and possibly threatening the chances of economic recovery or continuing to accommodate rapid money growth at the risk of raising the market's expectations of future inflation. In the absence of this, however, monetary pressures should be minimal until well into the second half of the year, when the recovery boosts transactions demand for money. As a result, interest rates should decline throughout most of 1983, with a modest backup in the fourth quarter.

Regarding financing activity, total credit-market borrowing will proceed at a somewhat stronger pace than the depressed 1982 levels. In general, borrowing in the first half of the year will be slower than in the second as government demands are seasonally weak. Moreover, business demands for expansionary funds—

The U.S. Economic Outlook *(continued from page 7)*

primarily to finance inventories—will not become significant until economic activity begins to recover strongly. The exception to this pattern will be mortgage activity, which, spurred by declines in mortgage rates and the slackening of home prices, will rise more rapidly in the first half of the year, as housing starts continue the climb they began late last year.

The business financing gap—investment and inventory outlays minus cash flow—will remain narrow early in the year, at about \$20 billion, as after-tax profits rebound to some extent and investment activity remains moribund. Even after midyear, this pattern may not change markedly, despite inventory buildups, since the profit picture is expected to be somewhat brighter in the second half of the year. Low capacity-utilization rates still expected to be in effect make it doubtful that much new fixed investment activity will take place in 1983.

Initially, new funds raised in credit markets will be concentrated in new issues of bonds and common stocks. Given the uncertainty over Federal Reserve policy, the relatively low bond yields and high stock prices available at the end of the 1982 may be perceived as temporary phenomena that constitute a "window" for long-term financing opportunities. Indeed, much of the proceeds from these issues may be used for rebuilding liquidity, repaying bank loans, and retiring commercial-paper obligations. In the second half of the year, more recourse to short-term financing is likely, given the needs to finance inventory positions. The possible "fly in the ointment" here could show up in the event that—because of an interest-rate spike or some other reason—the recovery fails to materialize. Under these circumstances, a boom in short-term borrowing, similar to the distress borrowing that occurred in the first half of 1982, may take shape in the second half of the year.

U.S. current-account prospects

The strength of any world recovery will be the dominant influence on the U.S. external accounts in 1983. Domestic real economic growth is likely to be stronger than in the major foreign economies, tending to boost imports and hold down export growth. The consequent widening of the trade deficit will not be offset by an increase in the flow of services or financial assets, so the current-account deficit will also increase considerably. The strength of the dollar on the foreign-exchange markets in the past year will reinforce these trends. If the recent narrowing of real interest-rate differentials persists and the dollar's recent slide continues—both of which seem likely, although at slower rates—the trade balance as well as the current account could at least stabilize toward the end of 1983. Such a development would help ease the grow-

ing protectionist sentiments that threaten what promises to be an extremely fragile worldwide recovery.

At least partly because of an anemic U.S. recovery, real growth in the other OECD countries is projected to be only 1½%-2%, as much as 1% lower than U.S. growth. This growth differential implies that import demand in the United States will rise more rapidly than that of its trading partners. This will be particularly true since U.S. imports are concentrated in consumption items, for which demand normally rises rapidly during a recovery. Oil accounts for nearly 25% of the volume of U.S. imports. However, the current excess supply of oil is likely to continue to put downward pressure on prices, so that America's oil import bill may not rise at all. Imports of other items are unlikely to grow by more than 10% in value terms, or about 5% in volume terms, chiefly because of the subdued pace of the recovery. Furthermore, the current weakening of the dollar will begin to have an adverse impact on import prices and volume during the second half of the year.

Demand for American exports will also suffer as a result of the stronger economic growth in the United States relative to other industrialized nations. The demand for capital equipment, which constitutes about 40% of U.S. exports, is generally sluggish in the early stages of a recovery. Another 15%-20% of U.S. exports is made up of agricultural products, whose volume is dependent upon the vagaries of the weather both at home and abroad. U.S. farm exports are likely to increase in volume terms. However, continued low commodity prices may cause the value of agricultural exports to decline for the second year in a row.

All in all, the merchandise trade deficit could deteriorate to \$60 billion in 1983 from nearly \$40 billion in 1982. The surplus on services and remittances, although still quite large, is likely to shrink somewhat, as well. Thus, 1982's current-account deficit—estimated at about \$2 billion—could swell upwards to \$20 billion in 1983.

The slow worldwide recovery will intensify competition in many markets, with the possible consequence of severe trade conflicts. Squabbles over declining industries such as steel and automobiles have already spawned protectionist legislation in many of the OECD countries—for example, the proposed local-content requirement for American autos now being considered by the U.S. Congress. The combination of rising protectionism and the slow recovery is likely to hold the overall growth in the volume of world trade to less than 3%. Even with the U.S. trade balance deteriorating considerably, however, this projection does not leave much room for the United States to provide other nations of the world with export-led recoveries.

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China Poised for Investment and Import Surge

After four years of austerity and readjustment, China appears ready for a modest dose of reflation. Capital investment and government expenditures in general were sharply reduced in 1981 and held down last year as well. However, spending is projected to rise this year. Two major complexes have been identified for accelerated development in 1983-85: machinery production in the Shanghai region and coal and railroad development in northern China. At the same time, less emphasis will be given to the special economic zones along the coast.

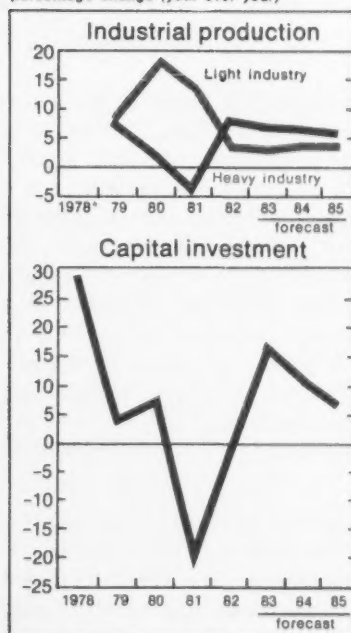
China is overdue for a new surge in machinery and technology purchases from Japan, the United States, and Western Europe. The financial resources have been there for some time. During 1981-82, export growth—along with import restraint and increased income from services and transfers—produced a total current-account surplus of at least \$6 billion. By the end of last September, foreign-exchange reserves had climbed above \$9 billion—an embarrassing level for a poor nation seeking long-term development loans and economic assistance. Bottlenecks were a serious problem during the last construction boom, but readjustment has increased domestic capacity to absorb Western machinery. Furthermore, the current weakness of world trade makes this an optimal time for purchasing capital goods.

China's expansionary phase might have begun in 1982 but did not. There were a number of restraining economic conditions: High interest rates, foreign protectionism against Chinese manufactured goods, and global economic uncertainty all tended to reinforce the financial conservatism of the present Party leadership. In addition, the last year has seen a major reorganization of the government bureaucracy—another reason for postponing rapid growth in construction until certain officials were retired. However, political forces should not seriously inhibit this push to build new infrastructure and modernize technology.

All in all, the mid-1980s should be a period of growth and stability for China; improvements in industrial balance and continuing growth in agricultural output should sustain GNP growth at around 5% per year. Economic conflicts among central planners, provincial authorities, and managers over investment funds and foreign capital are inevitable. But these strains simply reflect real tradeoffs under modernization and should be manageable over the next three years. Over the longer run, however, more significant changes in the Chinese economic system will be necessary—primarily in the price mechanism, the allocation of labor and investment, and the management of foreign trade.

Industrial output and capital investment in China

percentage change (year over year)



*data unavailable

*Falling pound
may force the hand
of U.K. government.*

The pound sterling has been on a downtrend again after the short pause that followed November's interest-rate hike. Since the end of November it has slipped from DM 4.01 to DM 3.70 and—even against a weaker dollar—from \$1.62 to \$1.57. These figures compare with DM 4.32 and \$1.93 at the start of 1982. Britain's economy has not yet shown any changes that would justify this rapid fall; indeed, domestic inflation is still falling rapidly, with the latest (November) figure showing a year-over-year rate of just 6.3%. Several negative influences, however, have led to pre-emptive selling of the pound. These include: forecasts for 1983, which show output picking up; a declining current account; uncertainties over the course of oil prices and over the timing and outcome of the next election; and government statements last autumn that sterling seemed to be overvalued. If the pound continues to fall, the government will have to give the currency further protection. Its hope is that interest rates will soon fall in the United States and elsewhere, so that leaving U.K. rates unchanged will be enough to protect the pound. If rates elsewhere remain at today's levels, however, the Bank of England would push U.K. rates up in order to widen the differential in favor of sterling.

*Inflation surge
in Switzerland
should be short-lived.*

Although the annual rate of inflation in Switzerland—now around 6%—currently exceeds that of the United States and Germany, there appears to be little reason for concern over possible long-term consequences. In fact, both short- and long-run forces seem to be operating to limit inflation. In the near term, falling mortgage rates, declining gasoline prices, and a stronger currency in terms of the dollar will help to contain price increases. For the longer run, central-bank money has grown at an average annual rate of only a little over 3% since 1977. As a result, there does not seem to be any significant shift away from the low levels of inflation enjoyed by Switzerland since the mid-1970s. Thus, there is little reason to suppose that Swiss interest rates will not decline in line with an expected fall in U.S. and German interest rates. Indeed, at the beginning of December the Swiss National Bank announced a half-percentage-point cut in its key lending rates. Moreover, in the long run, continued low inflation and a substantial current-account surplus will be reflected in a strong Swiss franc.

*Moderation marks
Spanish approach
to unemployment and
economic growth.*

The new Socialist government of Felipe Gonzalez took power in Spain in early December facing an unemployment level in excess of 2 million. It has stated that its prime objective is to create 800,000 jobs. Nevertheless, although a full economic program is not yet in place, most policy statements have pointed toward a moderate stance. The first major policy action was an 8% devaluation of the peseta—a move that followed substantial speculation and large reserve losses. Policymakers hope this move will help stimulate exports—and therefore the economy—although its success will depend on the ability to contain cost increases. In other actions the government increased cash reserve requirements for banks by one percentage point, raised oil and gasoline prices by more than 20%, and reduced the work week. In 1983 the new administration faces the problem of raising growth above the official estimate for 1982 of 1.3% while tackling the public-sector deficit, which is estimated to have reached 900 billion pesetas last year—some 4.5% of GDP.

*Mexico begins
tough adjustment
program.*

The Mexican government is in the initial phases of adjusting its economy to conform with an international support program tied to an IMF agreement. On December 23, 1982 the IMF approved a three-year \$3.9 billion extended arrangement. Approval of the IMF program is contingent upon Mexico's securing \$5 billion in net new financing in 1983 from commercial banks and another \$2 billion from official sources. In addition, some \$20 billion of public-sector debt due to commercial banks over the period August 23, 1982 to December 31, 1984 must be restructured. The key aim of the Mexican adjustment effort is to cut the public sector deficit from 16.5% of GDP in 1982 to 8.5% in 1983 and subsequently

down to 3.5% by 1985. Implementation of this program includes tax increases, spending and wage restraints, cuts in subsidies, and removal of price controls. Money and credit are also being controlled and interest rates are being allowed to rise in order to capture savings. The exchange rate has also been allowed to float and last week reached 150 pesos per U.S. dollar. These measures are certain to produce improvements in the fiscal and balance-of-payments accounts this year, but at considerable sacrifice—real GDP is likely to decline by some 3%-4% in 1983, after near-zero growth last year.

Range of medium and heavy industries planned for Malaysia.

Malaysian Prime Minister Mahathir Mohamad has undertaken a major shift in economic policy designed to develop medium-to-heavy industry. The new policy reflects both policymakers' desire to reduce the country's dependence on primary commodities and an acknowledgment of the limited growth potential in the labor-intensive export industries on which much of Malaysia's industrial development has focused up to now. Among the projects contemplated are: two sponge iron plants, a methanol plant, an ASEAN ammonia-urea plant, two petroleum refineries, a paper-pulp plant, expanded cement-production capacity, a cold-rolled sheet steel mill, and an automobile plant. Most of these will draw heavily on Malaysia's oil and gas resources. Furthermore, many of the projects are likely to involve Japanese or Korean investment. The auto manufacturing project is now in the limelight. Production is planned for the domestic market, with tariff protection as necessary. Since Malaysian demand for new autos is currently only about 100,000 per year, the project will have to capture a dominant share of the market. The degree of protection might therefore have to be large, and the economic viability of the project is certain to be controversial.

Efforts to hike public-utility prices in Thailand hit wall of opposition.

The government of Thailand has encountered severe problems in implementing badly needed policy reforms aimed at bringing prices charged by public utilities more in line with costs. Consequently, subsidies to ailing and inefficient state enterprises remain a serious drain on the Thai budget at a time when the generally depressed state of the economy is causing large revenue shortfalls and widening deficits. In late November, public protests forced the government to rescind an increase in the bus fare. The bus company alone has accumulated an estimated 3.5-billion baht loss over the last seven years—largely because of its inability to adjust prices quickly in response to higher fuel and other operating costs. Steps to improve the profitability of public enterprises are critical to Thailand's structural adjustment. But, in early December, in the wake of the protests over the bus fare increase, the Thai Communications Ministry reportedly postponed an earlier decision to raise politically sensitive passenger-train fares—an action that could result in a sharp increase in the losses of the state railway.

Cameroon's deficit financing expected to remain manageable.

The current state of Cameroon's economy must be characterized as mixed. Oil output is estimated to have risen to 106,000 b/d in 1982 from 88,000 b/d the year before, but oil well development has slowed. Earlier projections of 200,000 b/d annual output by 1985 have been scaled back, and it now appears that production may stabilize at the 140,000-160,000 b/d level. Plans for an LNG plant have been shelved in view of lower reserves than previously estimated. Moreover, both the aluminum and timber industries are experiencing severe financial problems. By contrast, substantial public-sector outlays continue to feed the construction and road-building industries. In the external sector, only a minor improvement in the current-account deficit from the \$375 million estimated for 1982 can be expected this year. Nevertheless Cameroon's relatively "underborrowed" financial condition and the continued inflow of direct investment should ease any deficit financing problem and contain debt-service obligations within manageable limits.

Consumers Not Ready to Lead Recovery

The sharp rise in housing activity in the past few months sparked a general expectation that the end of the recession—if not already here—was at least at hand. However, the housing sector is not large enough to lead the economy into a recovery by itself. As always, consumer spending remains the key to sustained expansion. But recent evidence indicates that consumers may be inclined to keep a tight grip on their wallets a bit longer.

A strong Christmas shopping season would have done much to reinforce the idea that a recovery was about to begin. But last week, the Commerce Department reported that retail sales fell by 0.4% in December. After three consecutive increases in September, October, and November, the news came as a major disappointment. Much of the drop in retail sales can be blamed on auto sales—down 4.1% in December after a 12.5% jump in November, thanks to the elimination of special sales incentive programs. The performance of other sectors was steadier—although weaker on balance—with a rise of 0.5% in December on the heels of November's 0.4%.

Special conditions such as auto rebates can lead to temporary spurts in sales. However, in the longer run, the growth in personal after-tax income acts as a constraint on overall consumer spending. Over the last six months, consumers' disposable income grew at a 7% annual rate, while their expenditures grew at an 8.7%

annual rate. This higher rate of spending could only have come about because the share of income going to savings fell from 6.6% in June to an estimated 5.8% in December.

If consumers felt confident about their own economic futures, this drop in the savings rate would not be particularly troublesome. However, with the unemployment picture continuing to worsen and unlikely to improve much before 1984, consumers probably will want to rebuild their savings as a precautionary measure. The Conference Board's indexes of consumer sentiment and buying plans fell in December. Moreover, consumers have continued to exercise caution in their use of credit and have been unwilling to take on debt faster than the growth in their incomes.

In addition to the fear of unemployment, there are also positive incentives for consumers to save. Despite their declines of the last several months, interest rates remain high on a historical basis. And deregulation has allowed financial institutions to create high-yielding instruments that have been quite favorably received.

Thus, any gains in spending over the next several months can be expected to be moderate, at best, as consumers attempt to shore up their savings. This higher level of savings will be helpful in financing the estimated \$200 billion federal budget deficit. But to the extent that consumers do increase their saving, the onset of the economic recovery may be delayed.

Douglas L. Bendi

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE			
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered
Algeria	Budgeted expenditure for 1983 is \$21.5 billion—16.4% higher than last year's.	Oct.	— 20%	36.0*	1,935	Nov.	2,499	—35%	1.0
Cameroon	Oil output projected to rise to 125,000 b/d in 1983.	Feb.	+ 20%	7.8	890	May	28	—68%	0.3
Egypt	Official projects foreign loan requirement of \$6 billion for 1982-87.	June	— 24%	30.8	710	Sept.	716	—16%	1.3
Ethiopia	Drought in Tigre region affects food production.	March	— 6%	4.2	132	Nov.	205	—20%	3.2
Gabon	Elf Gabon's discovery of two new oil fields should halt steady oil output decline.	Dec '81	+ 10%	3.4	6,180	July	379	+43%	n. a.
Ivory Coast	Austere 1983 budget shows 25% capital outlay reduction, 5% increase in operating budget.	Aug.	— 16%	9.8	1,190	Sept.	2	—76%	0.0
Kenya	Factories face shortages of industrial raw materials and spare parts.	April	— 6%	6.6	383	Nov.	179	—33%	1.1
Madagascar	Serious deterioration of roads and railways impedes development.	Dec. '80	— 27%	3.8	420	May '80	9	—80%	0.2
Morocco	Economic growth was 4%-5% in 1982, a sharp turnaround from 1981's 1.3% decline.	July	— 16%	15.2	735	Oct.	158	—13%	0.4
Nigeria	Incomes-policy guidelines extended to 1983.	Oct.	+ 22%	86.8	1,125	Oct.	1,543	—70%	0.9
South Africa	Last year's tighter monetary policy should result in greater price stability in 1983.	Oct.	— 17%	77.5	2,573	Nov.	908	+34%	0.6
Tunisia	State budget for 1983 projects an outlay of nearly \$3 billion—up 15% from 1982.	July	— 14%	8.1	1,240	Nov.	581	—12%	1.9
Zimbabwe	Wage-control regulations amended to permit selective increments and dismissals for economic reasons.	Aug.	— 11%	6.7	870	Nov.	137	— 5%	1.1
Iran	Government to continue policy of economic austerity despite rising oil revenues.	Oct.	+163%	n. a.	n. a.	June '80	15,478	+41%	16.5
Jordan	Government to raise large Eurodollar loan.	April	+ 15%	4.5	1,341	Oct.	991	—13%	3.5
Kuwait	Huge \$1.3 billion petrochemical project reportedly cancelled.	May	— 30%	24.3	17,350	Nov.	5,586	+50%	7.2
Qatar	Long-term development focus to shift from industry to social services.	Oct.	— 12%	5.0*	23,000	Jan. '82	393	n. a.	2.9
Saudi Arabia	Government reported slowing down advance payments on some projects.	Oct.	— 35%	155.8	16,719	Nov.	28,898	— 8%	3.0

*1980

BEST AVAILABLE

The Fed's Monetary Policy Dilemma

Last week's publication of the December monthly monetary data confirmed that in 1982 both M1 and M2 exceeded the upper end of the Federal Reserve's annual target growth paths. This is not really surprising, given the shift in monetary policy since October. However, market perceptions of the inflationary consequences of the new policy have recently changed.

For the past three months, concern over the weak economy and the conviction that money supply data were being distorted by technical factors—maturing All-Savers certificates and bank money-market accounts—have led the Federal Reserve to shift its concern from the management of monetary aggregates to reducing the level of nominal interest rates. Although the commodity, foreign exchange, and bond markets initially reacted quite favorably to this return to interest-rate targeting, their mood has now begun to change. Commodity prices, including gold, have begun to turn upward, the dollar has dropped precipitously, and bond yields have firmed.

These developments reflect not so much a lack of confidence in the new policy per se, but rather a disappointment that the growth of the monetary aggregates—however distorted they might be—has failed to slow down. The problem is that, by switching to interest-rate targeting, the Fed has given up its old instrument for reducing monetary growth—rising interest rates. Instead, it must hope that the ex-

ternal events that brought about the rapid money growth, such as buildups in precautionary balances, surges in stock and bond market volume, and the introduction of new deposit instruments, will naturally reverse themselves or be offset by countervailing external forces. It is the possibility that this scenario may not materialize, as well as the experience of the 1970s—suggesting that two consecutive years of rapid money growth spells a resurgence of inflation—that is currently fueling the market's apprehensions.

In lieu of a slowdown in money growth, the Fed's strategy for allaying the market's fears will become apparent when Chairman Volcker testifies before Congress on February 20. At that time, he will probably propose a set of money redefinitions. Although this gambit may "buy time," it will not solve the basic problem if money—however measured—continues to surge for several more months. In such an event, Fed policymakers will be forced to make a difficult choice: Either they can return to non-borrowed reserve targeting, at the risk that the ensuing tightening will cause short-term rates to rise; or they can continue to accommodate the money bulge, possibly heightening inflationary expectations and bringing about a steepening of the yield curve. Either option could easily lead to another cyclical downturn in the economy, defeating the purpose of the original policy change.

Carl Alan Batlin

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
of IMF \$B, mil. of dollars	current influences on payments	12-month changes				exchange rate	change from	current monetary conditions	
		latest data	consumer prices	latest data	money supply(M1)	in U.S. dollars January	year earlier 12, 1983		
0	Jan.-Oct. 1982 oil output averaged 682,000 b/d, 17% below 1981 period.	Dec. '80	+10%	Dec. '81	+16%	.2125	- 8%	Foreign-exchange reserves to Nov. down \$1.2 billion.	Algeria
1	Cocoa and coffee stocks rise, reflecting slowdown in sales.	Aug. '81	+ 9%	July	+29%	.0030	-12%	Credit tightness continues.	Cameroon
58	Oil prices cut twice in December—by as much as \$1.60 per barrel.	July	+17%	Sept.	+25%	1.2050	- 2%	Foreign-exchange reserves holding steady.	Egypt
29	Coffee earnings unlikely to rise markedly despite firmer prices.	May	+ 5%	Sept.	+ 9%	.4868	+ 1%	Credit restraint continues.	Ethiopia
12	Economic growth turns positive after period of austerity.	July '81	+ 7%	July	+ 21%	.0030	-12%	ECGD grants \$100 mn. credit for Trans-Gabonais.	Gabon
69	Oil development slows; 1983 output projections lowered to 30,000 b/d.	July	+12%	June	+ 4%	.0030	-13%	Credit squeeze continues.	Ivory Coast
35	Severe foreign-exchange shortage causes delays in import license approvals.	July	+20%	Oct.	+14%	.0900	-19%	Bank lending rates increased to 16% from 14%.	Kenya
26	New foreign exchange allocations favor raw materials and spare parts.	May '81	+39%	n. a.	n. a.	.0028	-20%	Foreign-exchange shortage has caused payment delays.	Madagascar
50	Phosphate rock prices have held at \$40 per ton since July 1982.	June	+ 9%	June	+12%	.1860	- 2%	Money supply growing steadily.	Morocco
0	New import restrictions cover all industrial and construction equipment.	Dec. '81	+17%	June	+ 5%	1.4967	- 5%	Foreign trade payments three months behind.	Nigeria
58	Slowdown in business activity is reducing demand for imports.	Oct.	+14%	Sept.	+26%	.9400	- 9%	Availability of funds improving.	South Africa
0	Oil output fell slightly last year.	May	+13%	July	+14%	1.6800	-17%	Gross foreign assets holding steady.	Tunisia
0	Aid disbursements should speed up, cushioning strained payments situation.	Oct.	+18%	Aug.	+12%	1.1100	-23%	Devaluation could add 6 pctge. pts. to consumer price level.	Zimbabwe
0	Oil output now 2.7 mbd—rose 34% during Jan.-Oct. from 1981 average.	Sept.	+19%	Feb. '81	+34%	.0120	- 4%	Foreign-exchange reserves up sharply in 1982 second-half.	Iran
0	Phosphate rock export prices fell about 13% during 1982.	Sept.	+ 7%	Aug.	+14%	2.8500	- 5%	Bank claims on government rising steadily.	Jordan
0	Oil output averaged 675,000 b/d for Jan.-Oct. 1982—31% below 1981 period.	Feb.	+ 7%	Sept.	+24%	3.4700	- 2%	Growth of money supply slowing.	Kuwait
0	Jan.-Nov. 1982 average oil output was 330,262 b/d, down 20% from 1981.	n. a.	n. a.	March	+50%	.3448	+24%	Foreign assets holding steady.	Qatar
0	Average oil output from Aramco fields reported down to 5.1 mbd in Dec.	Sept.	- 1%	Aug.	+20%	.2907	- 1%	Foreign-exchange reserves to Nov. down \$3.34 billion.	Saudi Arabia

World Interest Rates

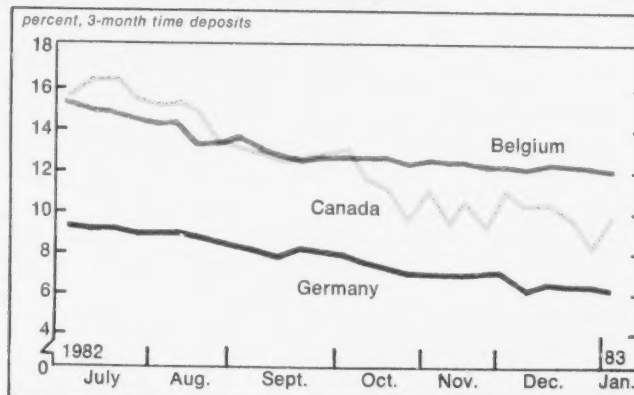
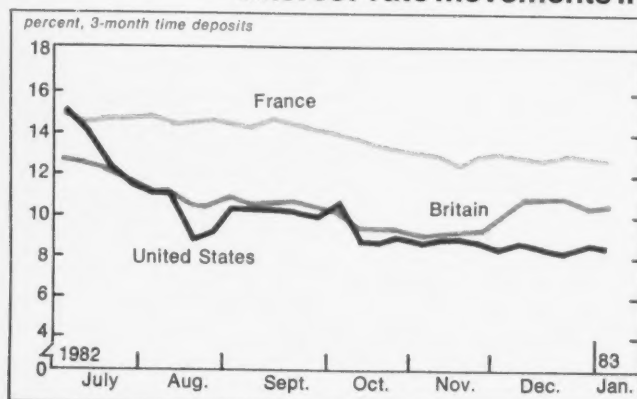
market rates of Jan. 12, 1983; bond yields as of Jan. 7, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.74	10.00 intervention rate	11.50	9.50	5.00	18.00 penalty rate 21.00	5.00	4.50	5.50
Day-to-Day Money	8.50 January 13	15.00	11.00	8.45	12.75	5.85	19.00	5.50	1.00 1-month Euro-Swiss fr. rate	6.5625
Treasury Bills 91-day, Middle Rates	7.66	9.50	11.00	12.25	n. a.	n. a.	18.10 77 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.75 finance paper 15% tax w/h	10.615	11.40 Certified	n. a. Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.05	9.60 15% tax w/h	11.0625	11.40 Certified	not traded	6.50	20.00	no market	2.875	no market
Government Bonds Long-term, new and old issues, average yield	10.68	12.40	10.90	10.83	14.53	7.70	19.37	7.63	4.21	7.102
Industrial Bonds prime, long-term, new and old issues, average yield	11.55 Aa Industrials	12.50	13.29	13.29	15.72	7.90	19.49	8.26	5.62	6.38
Bank Short-Term Rate to Best Borrowers (prime rate)	11.00	12.00	12.00	15.50	14.80	9.00	20.75 ¼ qtrly fee on outstg.	7.50	8.50	6.00
Bank Time Deposits 3-month	8.125 Cert. of Dep.	9.875	11.6875	12.00	12.625	5.55	11.50	5.25 large deposits	2.50 residents only	3.75
Eurocurrencies 3-month, asked	8.8125	9.975	11.75	no market	22.25	5.4375	no market	4.9375	2.625	6.375
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8190	1.5795	.021672	.1503	.4258	.000742	.3964	.5186	.00436
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	0.978 D	2.659 D	5.519 D	12.774 D	3.476 P	14.555 D	3.934 P	6.170 P	2.385 P

Eurodollar Deposits (London, interbank, bid) January 13	International Arbitrage (3-month, hedged) + in favor of U.S. dollars	Eurobonds (average yield on recent straight debt issues)	Gold Price
7-day 8.875	U.S.-U.K. Treasury Bills -0.530	U.S. Dollar Bonds	London afternoon fixing
1-month 8.75	U.S.-Canada Treasury Bills -0.515	7 yrs. and under 10.70	
3-month 8.75	U.S.-Canada Finance Co. Paper -0.138	Over 7 yrs. 11.00	
6-month 8.875	Eurodollars-U.K. Local Auth. Deposits +0.034	DM Bonds	480.50 (per fine ounce)
		7 yrs. and under 8.00	
		Over 7 yrs. 7.75	

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Interest-rate movements in selected industrial countries



The Nature of the LDC Debt Problem

The following is adapted from remarks given by William S. Ogden, Vice Chairman of The Chase Manhattan Bank, N.A., before the Manhattan Institute of Policy Research in New York late last year.

In interpreting the so-called LDC debt crisis, the financial and popular press have often overlooked several critical points. First and foremost, the current LDC debt problem is a problem of *illiquidity* not *insolvency*. Second, the LDC debt difficulties represent a problem not just for the international banks, but for the entire world economy, since the dimensions of the current global recession are ultimately what is at stake. Finally, our collective capability to prevent the present liquidity crisis from escalating into a vicious circle of economic and political dislocations has frequently been underestimated. Liquidity problems are readily solvable. But they rarely solve themselves if ignored.

Liquidity not solvency

The tone of much of the media discussion seems to imply that LDC debt has been built to unserviceable levels. Undeniably, the current levels of debt are high. On the eve of the first oil price shock in 1973, the total foreign debt—public and private, long-term and short-term—of non-OPEC developing countries was slightly less than \$100 billion. By the end of 1981, this total had grown to roughly \$470 billion, and it is estimated that another \$60 billion or so has been added in 1982. Commercial bank lending accounted for a large proportion of this increase.

These are extremely large numbers. But they must be put into perspective relative to the greatly expanded productive capacity of the LDCs. Contrary to some reports, relatively little of the increase in debt over the past eight years has been used simply to sustain consumption. Rather, most has underwritten increased investment.

I do not want to imply that the level of borrowing by the LDCs has been optimal or that it could have continued growing indefinitely at the pace of recent years. The developing countries as a whole have, in fact, been far too slow in adjusting their growth ambitions to the realities of a world economy grappling with disinflation. The resources borrowed have not always been utilized efficiently. But the debt buildup has not been wildly imprudent.

Why then is there an LDC debt problem? The problem arises out of the difference in debt-service capability in the short run versus the long run—between the actual ability to export and the capacity to produce for export. Neither borrowers nor lenders anticipated a prolonged recession in the industrialized nations—nor, for that matter, did the policymakers in the industrialized countries.

The fall of commodity prices and the worldwide recession have slowed dramatically the growth of exports from the developing countries and hence *temporarily* reduced debt-service capacity. Inflation expectations in financial markets have been slow to respond to disinflationary policies in the industrialized countries. This has resulted in unusually high real interest rates and thus temporarily increased debt-service flows.

Consequently, there has been a rapid deterioration in the capacity to service public debt as it is conventionally measured. The debt-service ratio for the non-oil developing economies as a whole—calculated as the ratio of interest and amortization on medium- and long-term debt to total exports of goods and services—has climbed from roughly 16% in 1980 to an estimated 25% in 1982. Of even greater significance, the ratio of interest payments on total foreign debt to total exports has increased from less than 8% in 1980 to an estimated 14% in 1982. For some of the major borrowing countries—particularly in Latin America—these indexes of debt-service burden are even higher, with total foreign interest payments running as high as 45% of total exports.

Even so, the immediate cause of the present liquidity problems of many developing countries is the increasing unwillingness of the international financial community to lend. In questioning the short-run debt-service capability of countries possessing a large foreign debt burden, the market has engineered an abrupt, relatively synchronized reduction in the availability of new foreign credits. This essentially guarantees the impossibility of normal debt service.

For many countries, particularly in Latin America, important segments of the market for foreign lending have virtually disappeared—in particular, regional bank participation in international loan syndication and private placements intermediated by the investment banks. Until debt-service uncertainties are resolved, the flow of available credit will be sharply curtailed. Moreover, the resolution of those uncertainties in many instances will entail debt reschedulings that will take a significant period of time to prove their workability.

The result is that there are now in place the basic elements of a classic liquidity squeeze: a rapid buildup of a stock of assets of relatively long maturity, funded by the issuance of debt of significantly shorter maturity; a global recession, which has temporarily thrown into question the ability of the debtor to service those debts; and a scramble on the part of many debt-holders

The Nature of the LDC Debt Problem *(continued from page 7)*

to liquidate their portions of that debt. We have a serious problem. But it is a liquidity problem, not a solvency problem—unless one believes that the industrialized nations are doomed to long-term stagnation.

Bank viability

A second key point is that the most important problem arising out of the current LDC debt-service difficulties is not the viability of the international banks but rather the possibility of a significantly worsened world recession.

The international banks face a negligible risk of permanent default or debt denial, because sovereign borrowers cannot cease to exist. Permanent default implies both a long-term loss of access to international private capital markets and a sharply reduced ability to utilize the international financial service network that is essential to the ordinary conduct of foreign trade.

However, there are indeed risks in the present environment: risks of significant delays, both in reestablishing the creditworthiness of a number of borrowing countries and in securing adequate rescheduling agreements—plus risks of failure to adhere to those agreements once negotiated. For the sovereign borrowers, there is a risk of a prolonged period of severely curtailed imports and of a serious decline in the overall level of domestic activity. For the international banks, there exist both a risk of losing the freedom to manage a significant proportion of their asset portfolio and a risk of a moderate, temporary fall in earnings. But this latter risk in no sense implies a threat to the *viability* of the banks. Even in circumstances where the proportion of assets-not-serviced relative to principal would increase well beyond current levels, the proportion of assets-not-serviced relative to interest would be comparatively small.

There is no way that the present debt difficulties of the developing economies can be resolved without the provision of further credits. Balance-of-payments deficits must be reduced sharply. But they cannot be eliminated overnight. New credits are needed. The proportion of this credit deriving from public and multilateral sources is inevitably going to increase, but relatively large flows of credit from private sources are still essential. Assembling these needed credits in an environment in which important elements of the market want to reduce exposure will be difficult.

The immediate problem is not that the banks will not be repaid but that they may not be in a position to continue lending. And yet without significant net new lending to the developing countries, the economic adjustment required of them will be catastrophically abrupt. The economic dislocations entailed in such an adjustment would threaten a breakdown of the political consensus existing in those countries. This, in turn,

would delay the adoption of the policies needed to reestablish creditworthiness. The impact of such a chain of events would by no means be contained within the developing countries themselves. We are members of an increasingly interdependent global economy. U.S. exports now total nearly one-tenth of our total gross national output, and more than one-third of those exports now go to developing countries that are critically dependent on continued access to private international credit markets. The loss of a significant proportion of those export markets would add markedly to our already appreciable unemployment lines.

Containing the problem

That, of course, is not an enviable prospect. Neither the borrowing governments, the international financial community, nor the multilateral institutions and governments of the industrialized nations can contain the current difficulties by themselves. However, it is well within our *collective* capability to prevent the present liquidity problems of the developing countries from escalating into a vicious circle of economic dislocations that would deepen and prolong the present global recession.

The borrowing countries must take strong measures to reduce their balance-of-payments deficits. It is inevitable that these measures will reduce economic growth—and in some cases actually lower the current level of economic activity.

The key responsibility of the private international financial community is to provide an adequate financing package to the countries with liquidity problems. To do so will require the cooperation of all segments of the private market.

The governments of the industrialized countries have no responsibility to guarantee a reasonable rate of growth to the developing economies at a time when the attainable rates of growth of their own economies are unreasonably low. These same governments have no responsibility to protect their banks from the consequences of imprudent behavior. But they do have responsibility for the provision of reasonable flows of liquidity on a global basis and for the provision of lender-of-last-resort facilities for their individual national banking systems.

The provision of reasonable flows of global liquidity is troublesome. This responsibility is exercised by central banks individually or, in some cases, collectively through the Bank for International Settlements and, at the government level, through the International Monetary Fund. Without a commitment to increased levels of multilateral credit to the developing countries in trouble, the availability of credit from private sources will shrink drastically. That would spell trouble for not only the banks but the entire global economy.

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Italy: Limited Room For Monetary Maneuvers

Italian policymakers have discovered the difficulty of attempting to combine large and growing public-sector deficits with a relatively restrictive monetary policy. Over the past three years the government's general borrowing requirement has climbed from some 9.4% of GDP in 1979 to over 12% in 1982. Including government lending activity along with the current and capital deficits of state-owned companies, the borrowing requirement of the enlarged public sector—known as the PSBR—approached 15% of GDP last year, compared with 13.8% in 1981.

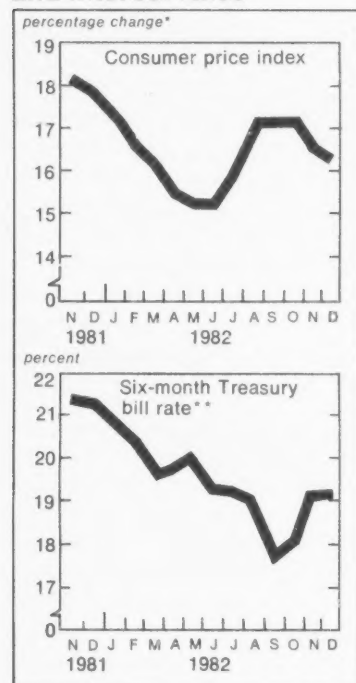
At the same time, the Bank of Italy has sought to follow a moderately restrictive monetary policy, both to hold inflation in check and to support the lira on the foreign-exchange markets. Despite the central bank's efforts, however, domestic credit expansion and Italy's various measures of the monetary aggregates accelerated significantly in the second half of last year. For 1982 as a whole, domestic credit grew by an estimated 21%, much faster than either the originally targeted figure of some 15% or the actual inflation rate of about 16%. Growth of the broadly defined money stock was more moderate—mainly as a result of Italy's current-account deficit.

The overshooting stemmed almost entirely from a fundamental economic reality: that the public sector's financial needs—which amounted to around 70% of total domestic credit last year—must ultimately be met. There are limits to the degree of credit restraint that can be applied to the private sector if it is to continue to function; as it was, private-sector credit growth last year was held to an estimated 13%. In the end, the monetary authorities will undoubtedly be forced to allow a faster rate of credit expansion to avoid further crowding out of private investment.

For the financial markets, this carries the risk of destabilization. Rekindled inflation expectations will be reflected in the bond and foreign-exchange markets. Uncertainties over future financial policy may then increase the risk premium on short-term government borrowing.

The Italian authorities appear to be aware of these problems. The Bank of Italy has moved to offset a part of the increase in total credit growth by raising banks' reserve requirements. More important, the Fanfani government has proposed a series of measures, mainly higher taxes, that would hold the 1983 PSBR at 15% of GDP. If policies remain unchanged, the figure is projected to rise to 17%. But, it still remains to be seen whether a sufficient political consensus will develop for a significant *reduction* in the PSBR/GDP ratio—a necessary condition if the Italian monetary authorities are to regain room for policy maneuvering.

Italian inflation
and interest rates



*year over year
**tax free

*Recent improvements
in French labor market
expected to be
short-lived.*

*Austrian government
budget feeling
effects of recession.*

*Morocco's record
current-account deficit
expected to improve
this year.*

*Restrictive measures
aimed at restoring
balance to
Costa Rican economy.*

The French unemployment problem appears ready to take a turn for the worse. The small reduction in the seasonally adjusted number of unemployed seen in the final months of 1982—to just over 2 million in December—is likely to be reversed over the course of 1983. For one thing, technical and probably temporary influences were at work in the latter part of last year. For another, the economy is unlikely to grow quickly enough to extend the recent downtrend in unemployment. The official government forecast predicts real GDP growth of only 2%. And even that figure is looking increasingly optimistic in view of both the economic recovery expected in the rest of Europe and the need to reduce France's current-account deficit from the 85-billion-franc level reached in 1982. A more likely picture is for a real growth rate closer to 1% and a renewed upturn in unemployment by the second quarter of this year.

The continuing recession in Europe is putting pressure on Austria's public finances. Industrial production declined in the third quarter of 1982 and by October had fallen 2.7% below its year-earlier level. As a result, the unemployment rate had risen to 4.5% by November—up from 3.2% in November 1981 and well above the level of 3.3% assumed for the 1983 budget. Accordingly, the government's projection of a gross budget deficit for this year of 74 billion schillings—virtually unchanged from the 1982 deficit—appears to be too low. In view of this, Chancellor Kreisky has announced his intention to raise taxes in the latter part of 1983 if his party wins the election scheduled for April 24. The extra revenue—estimated at around 15 billion schillings in a full year—would be used in part, to create jobs and, in part, to reduce the budget deficit. Nevertheless, a lasting upturn in the Austrian economy must await a recovery in Germany, which is currently not expected until the second half of 1983.

According to preliminary estimates, Morocco's current-account deficit widened marginally last year to a record \$1.9 billion from \$1.84 billion in 1981. The deficit reflected an increase in the merchandise trade gap to \$1.7 billion from \$1.55 billion in the previous year, despite slower import growth. Softer world prices and more modest increases in the quantities of grain, sugar, and oil purchased held the 1982 rise in merchandise imports to 15% in local currency terms, compared with 34% in 1981. Nevertheless, the expansion of exports also slowed markedly—down to 7% last year compared with 24% in 1981—largely because of the weaker demand for phosphate rock. Had it not been for the continued growth in workers' remittances and tourist income, which partially offset the higher interest payments on external debt, the 1982 current-account gap would have been larger. The outlook for 1983 is more optimistic, however. The severe drought that had plagued Moroccan agriculture since 1980 finally ended last year, improving the chances of a good harvest this year. This and the prospects for lower oil prices, falling world interest rates, and stronger export growth suggest the current-account deficit will narrow significantly.

Within the context of an IMF standby arrangement, Costa Rica is undertaking a corrective austerity program centered on a restrictive fiscal stance. The overall public-sector deficit as a proportion of national income is expected to be lowered still further this year—down to 4.5% of GDP from an estimated 9.2% in 1982 and around 15% in 1981. To achieve this, a tax package was recently passed calling for an increase in the sales tax and an expansion in the number of goods taxed, a higher social security quota, an income tax surcharge, the elimination of food subsidies, and corrective price adjustments for publicly produced goods. In addition, expenditures—particularly capital outlays—are to be substantially curtailed. A lowered fiscal deficit, in turn, means that the government's borrowing requirements from the domestic banking system will be contained. This, the authorities hope, will help to curb total liquidity expansion to about 30% this year from 50% in 1982. While tight demand-management policies are crucial to lowering the country's current-account deficit, redressing the international payments position will also hinge on the successful rescheduling of the external debt presently under negotiation.

*Modest improvement
in Finnish economy
expected in 1983.*

*Slow growth for
Colombia, but
debt problems
likely to be avoided.*

*Indonesia—hard hit
in 1982—adopts
program of restraint.*

*Foreign banks
to be allowed to
set up operations
in Australia.*

The breakup of Finland's ruling coalition in December, after arguments over the country's 1983 defense budget, diverted attention away from economic problems for a while. But with a new government now in power, the economy has moved once again to center stage. Last year brought a growth slowdown as world markets for Finnish products became progressively more depressed. Falling oil revenues prompted the Soviet Union to cut back its purchases of Finnish exports, but there are hopes for some pickup this year. To help get the economy moving, the government has lowered employer taxes. And last October's 10.3% devaluation should give some boost to exports. Official forecasts from the Ministry of Finance point to economic growth of 2% in 1983, coupled with a 9% inflation rate. The overall balance of payments is expected to swing into a small surplus of some \$300 million, after a deficit in 1982 provisionally estimated at about \$500 million.

With the end of 1982, the Colombian economy marked its second consecutive year of below-par performance. Real GDP for the year is estimated to have been 1.5%, down from the 2.5% of the previous year and well below the 6% average growth of the 1970s. Restrictive monetary and fiscal policies, plus a decline of exports have been the primary causes of the slower growth. The overall balance of payments has shifted into deficit, principally as a result of a drop-off in invisibles and tourism earnings. International reserves (less gold) fell by \$1 billion between the end of 1981 and October 1982. Yet Colombia is doing well compared to other Latin American countries suffering from recession and external debt problems. The country has a modest amount of external debt relative to its economic size and, as a result of its traditionally cautious approach to external borrowings, has avoided the financial liquidity problems that have plagued other countries. Little change is expected for the economy in 1983: Moderate real growth of 2%-3% is possible, and external debt will probably be utilized for selected projects with good returns.

Indonesia's economy suffered a severe buffeting in 1982. Thanks to a waning oil market, gross income from oil exports fell by 19%. Weak world markets brought a 10% decline in Indonesia's non-oil exports, as well. Imports, however, continued to rise, as the government—with World Bank encouragement—pushed ahead on its development program. The result was a current-account deficit of \$6.57 billion. Faced with a continued large payments deficit and declining revenues, the government has announced an austere budget for fiscal 1983/84. Total expenditures will be held to an increase of only 6.1% from the current year's budget. Civil service salaries will be frozen for a second year. Subsidies on food will be eliminated and those on oil products and fertilizer reduced. In addition, the government has placed administrative restraints on imports of a wide variety of goods and indicated that plans for some major capital projects will be reviewed. Devaluation as a remedy has been formally rejected, but the rupiah has been allowed to depreciate gradually against the dollar. This slippage will probably continue over the rest of the year.

The Australian government has announced that it intends to admit a small number of foreign banks to full-service operation within Australia. This move is consistent with some of the recommendations of the Campbell Report, a government-mandated study of the Australian financial system completed in September 1981. The Campbell Report suggested that the long-standing embargo on non-resident participation in Australian banking be removed but that the rate of entry of foreign banks be closely managed. The report further recommended that resident equity participation not be required of the new foreign banks. The government, however, chose to focus on the "level and quality" of Australian ownership in considering the foreign applications for banking licenses. Some Australian banks have expressed reservations about allowing the entry of foreign banks. But the government apparently feels that the increased competition will benefit Australian savers and investors.

The Benefits of Recession

Recession, almost by definition, is a time of pain. But it can also be a time of economic adjustment that can have beneficial effects for the long run. Because the current recession has been longer and, in many ways, more severe than most, it may well provide a long-needed purging of a number of ills that have plagued the economy for some time—provided that policymakers can resist pressures for a short-run, quick-fix cure.

In large measure, the economy has been forced to bear the costs of the 1979 shift in Federal Reserve policy from targeting interest rates to targeting monetary aggregates, with the avowed purpose of slowing inflation. Consumer prices have indeed slowed, from a 13.3% rate of increase during 1979 to just 3.9% in 1982. The shift in Fed policy, however, has also brought higher interest rates—especially adjusted for inflation—and more volatility.

Consumers responded by cutting back on installment buying; new credit extensions as a share of income fell from a peak of just over 20% in mid-1979 to about 15% last fall. And corporations improved their balance sheets dramatically. New business debt increased at a rate of 19% during 1976-79 but has been roughly flat since then, and this has helped to stem the erosion of short-term assets relative to liabilities. Both of these changes mean that a larger share of any future gains in income can be used to finance

new spending rather than to pay off old debts.

Businesses were able to improve their balance sheets, despite falling sales, largely because of the severe cost-reducing measures they have undertaken. Current inventories are below 1979 levels in volume terms. And manufacturing payrolls are nearly 15% lower than their 1979 peak, which has helped to increase industrial productivity. Furthermore, wage gains have slowed, so that labor costs per unit of output rose only 6% in 1982 compared with more than 11% in 1979.

The protracted nature of the slump in activity has also forced businesses to reexamine their capacity needs. Many old and inefficient plants were being carried on company books in anticipation that they might someday be needed to fulfill peak demands. Now, however, such obsolete investments are being written off, improving the prospects for gains in earnings when demand does pick up. Already, corporate profits have shown some improvement—in the third quarter of last year and probably in the fourth as well—despite falling output.

The adjustments to lower inflation have by no means been painless. But they were necessary to avoid the continued ratcheting upward of inflation. If the Fed and the administration can now avoid overly rapid stimulation of the economy, a sustained non-inflationary recovery may well be their reward.

Douglas L. Bendi

Is Money Growth Still Important?

The sharp increase in M1 for the week ending January 12 was quickly interpreted by market participants as another disappointment for the Federal Reserve. The subsequent surge in interest rates, however, does not necessarily mean that the markets thought that money growth had finally gone far enough to make the Fed tighten. What it does appear to indicate is that the markets still feel money has a powerful effect on interest rates and on eventual Fed behavior, even if Fed reaction is not as quick or as severe as it used to be.

Although it has not been officially announced, the monetary authorities have clearly moved to interest-rate targeting. Thus, the importance to the markets of week-to-week movements in money growth has diminished, since the Fed is less likely to react to such data by quickly injecting or draining reserves. It remains to be seen how much the Fed's interest in money growth has waned, but it is worth noting that since the start of the current targeting year—the midpoint of the fourth quarter of 1982—the authorities have tolerated M1 growth at an annual rate of over 15%. As a result, market worries have to be mounting over when the Fed will once more become more concerned about the long-run effects of rapid money growth.

The rationale for such concern stems from the observed historical relationship of money to nominal (current-dollar) income. Nominal income contains both price and output components, but economists have noted that over the long run, money is much

more closely related to prices than to real output. This observation has led economists to the belief that money growth eventually must be contained if inflation is to be controlled. A failure to bring money back under control could lead to a reacceleration of inflation that would ultimately invoke a repeat performance of the 1979-82 anti-inflationary trauma, but starting at even higher levels of inflation and interest rates. It is the market participants' understanding of this that has caused them to ask how much longer the Fed can tolerate such massive growth in M1.

In this situation, the question of whether money growth is still important has two answers. Over the longer run, it clearly is. The larger-than-expected mid-January spurt in M1 caused Treasury-bill rates to rise sharply, even though the Fed has declared its intention to avoiding tightening in reaction to above-target money growth. Clearly, the markets are concerned that—whatever the Fed's immediate reaction—high money growth will eventually lead to high inflation and interest rates. They further believe that the Fed understands this and will act accordingly. In the near term, however, money growth is not that important either for understanding or for predicting the behavior of the monetary authorities. The magnitude of the Fed's reaction to money growth is much lower today than it was six months or a year ago, and clearly well below what the markets had become accustomed to since October 1979.

D. Sykes Wilford

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in \$ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes		central bank rate ^Δ in U.S. dollars	exchange rate in U.S. dollars	current monetary conditions			
												latest data	consumer prices				latest data		money supply(M1)
Austria	Government discusses tax hikes despite general election scheduled for April.	July	+ 2%	65.8	0	Nov.	4,769	+ 4%	3.0	0	Estimated 1982 current-account deficit was \$3.8 bn., down from 1981's \$5 bn.	Nov.	+ 5%	Oct.	+ 8%	5.75%	.0592	M3 growth in November was 16.6%, year on year.	Austria
Belgium	Economy continues to await upturn in rest of Europe; incomes policy in place for 1983.	Sept.	0	97.1	-2.0%	Nov.	4,199	-21%	1.0	0	Export profit margins improving in wake of devaluation and wage restraint.	Jan.	+ 8%	June	+ 1%	11.50%	.0212	Interest rate differential with Germany widens.	Belgium
Britain	Although consumer demand has risen steadily, output still shows no sign of responding.	Nov.	- 1%	523.8*	-1.8%*	Nov.	13,042	-16%	1.6	56	Nov. current-account surplus was £700 million, but rapid erosion still forecast.	Dec.	+ 5%	Oct.	+19%	11.00%	1.5480	Sterling weakness has forced rise in interest rates.	Britain
Denmark	Tough anti-inflation policy will keep activity low this year.	Sept.	+ 2%	55.9	-0.2%	Nov.	2,102	-22%	1.6	0	Jan.-Nov. 1982 trade deficit was Kr. 10.4 bn. vs. Kr. 8.7 bn. in same 1981 period.	Nov.	+10%	Sept.	+11%	10.00%	.1185	Interest rates still high despite Nov. discount rate cut.	Denmark
Finland	Growth expected to pick up this year after virtual stagnation in 1982.	Sept.	- 4%	48.3	+1.3%	Nov.	1,306	- 6%	1.2	16	Jan.-Nov. 1982 trade deficit was 399 mn. markka, vs. 194 mn. in 1981 period.	Nov.	+ 8%	Aug.	+18%	8.50%	.1873	Govt. forced to borrow 1 bn. markka from central bank.	Finland
France	Industrial production recovered somewhat in 1982 4th qtr.; 1% GDP growth expected in '83, at best.	Nov.	- 2%	657.8*	+0.3%	Oct.	13,043	-40%	1.4	0	Trade deficit in 1982 widened to FF 92.7 billion, vs. FF 60 billion in 1981.	Dec.	+ 9%	Aug.	+15%	9.50%	.1465	Franc in EMS remains fragile despite rate easing.	France
Germany	Real GNP fell an estimated 1.2% in 1982; upcoming election scheduled for March 6.	Nov.	- 7%	685.5	-0.2%	Nov.	43,440	- 3%	3.5	0	Export volume declining, but terms of trade are improving.	Dec.	+ 5%	Oct.	+ 6%	5.00%	.4155	Liquidity being eased despite pre-election weakness of DM.	Germany
Greece	Budget for 1983 seeks to reduce deficit relative to GNP despite 30% rise in public expenditure.	Aug.	-16%	38.0	-0.7%	Nov.	1,074	- 4%	1.4	0	Drachma devalued 15.5%, import quotas proposed to reduce trade deficit.	Oct.	+20%	July	+35%	20.50%	.0119	Credit continues to expand rapidly.	Greece
Ireland	Tough budget expected that will allow Ireland almost no growth this year.	Aug.	- 3%	16.2	+1.1%	Nov.	2,309	-15%	2.9	0	Trade deficit virtually eliminated toward the end of 1982, hopes raised for 1983.	Aug.	+17%	Oct.	+11%	14.00%	1.5480	Budget deficit and pound pressure keep rates high.	Ireland
Italy	Output continues to decline; wage indexation loosened.	Nov.	- 8%	350.6	-0.2%	Nov.	13,248	-29%	1.9	0	Trade deficit in Oct.-Nov. widens again compared with year-earlier levels.	Dec.	+16%	Aug.	+14%	18.00%	.000717	Prime rate reduced.	Italy
Netherlands	Economy continues to stagnate; inflation rate of 4.3% in 1982 was below German rate.	Nov.	- 6%	139.0	-1.1%	Nov.	9,195	- 1%	2.0	0	Current account continues in large surplus, upward pressure on guilder.	Dec.	+ 4%	Sept.	+ 8%	4.50%	.3776	Key interest rates reduced by half a point.	Netherlands
Norway	Some 1% growth in GDP is expected this year after 1982's 1.4% fall.	Oct.	- 4%	55.6	+0.8%	Nov.	7,304	+13%	5.9	0	Trade surplus for 1982 was Kr 14 billion, vs. Kr 15 billion in 1981.	Nov.	+11%	Aug.	+ 9%	9.00%	.1405	Stockmarket sharply revived after 1982 decline.	Norway
Portugal	The calling of early elections adds uncertainty to 1983 economic outlook.	May	- 1%	23.5*	+5.5%*	Oct.	503	-18%	0.6	11	Current-account deficit for 1982 est. at \$3 bn.; year-end external debt \$12 bn.	Sept.	+21%	June	+11%	19.00%	.0105	Credit controls continue to keep situation tight.	Portugal
Spain	Budget for 1983 yet to be formulated.	May	+ 1%	183.7	+0.3%	Oct.	7,610	-33%	2.9	19	Current-account deficit for 1982 est. at \$3.8 bn., down from 1981's \$5 bn.	Oct.	+14%	Sept.	+16%	8.00%	.00781	M3 growth in Nov. was 16.6%, year on year.	Spain
Sweden	Sweden's 1983/84 budget aims for export-led growth.	Sept.	- 1%	111.5	-0.7%	Nov.	4,289	+20%	1.9	0	Jan.-Nov. 1982 trade deficit was Kr 4.8 bn., vs. Kr 1.3 bn. in 1981 period.	Dec.	+10%	Oct.	+10%	10.00%	.1356	Central bank discount rate cut.	Sweden
Switzerland	Domestic activity remains low and 1983's GDP is expected to fall lower than 1982's.	June	- 3%	99.4	+2.0%	Nov.	13,530	+30%	5.9	0	Trade deficit in 1982 was SF 5.4 billion, vs. SF 7.3 billion in 1981.	Dec.	+ 6%	Sept.	+31%	4.50%	.5074	Interest rates down owing to franc strength.	Switzerland
Canada	End of recession awaits U.S. recovery; real GDP down 9% since June 1981.	Nov.	-12%	276.4	+3.1%	Nov.	2,898	-22%	0.6	0	First whole-year current-account surplus in a decade estimated for 1982.	Dec.	+ 9%	Oct.	+ 5%	9.81%	.8104	Interest rates ease; bank rate in single digits.	Canada
United States	Production looks set to rise in early 1983 to restock inventories after rapid liquidation.	Dec.	- 6%	2,937.7	+1.9%	Nov.	22,858	+15%	1.0	0	Trade balance to show marked deterioration in first half of 1983.	Dec.	+ 4%	Dec.	+ 8%	8.50%	—	Large govt. deficit creating upward pressure on rates.	United States

*1980

△most recently reported

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World Interest Rates

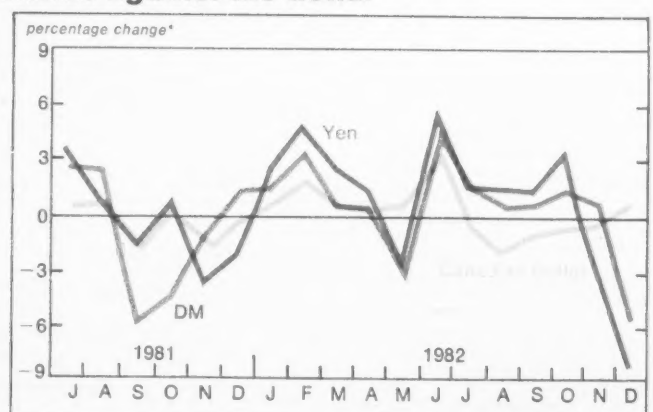
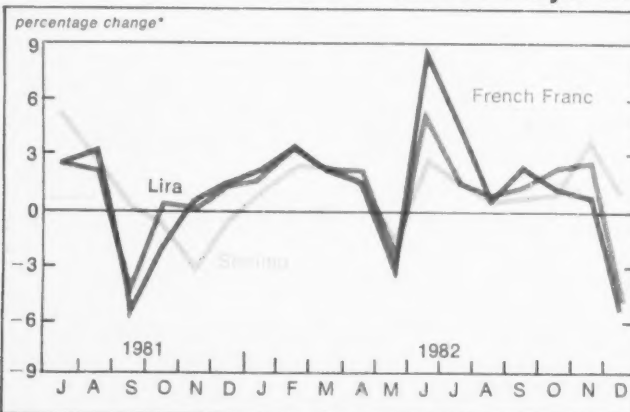
market rates of Jan. 26, 1983; bond yields as of Jan. 21, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.81	11.00 intervention rate	11.50	9.50	5.00	18.00 penalty rate 21.00	4.50	4.50	5.50
Day-to-Day Money	8.25 January 27	11.00	11.50	7.45	12.50	6.00	19.00	3.75	0.75 1-month Euro-Swiss fr. rate	6.8125
Treasury Bills 91-day, Middle Rates	8.12	9.50	11.0625	12.25	n. a.	n. a.	17.604 63 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.90 finance paper 15% tax w/h	n. a.	11.40 Certified	12.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.35	9.80 15% tax w/h	11.125	11.40 Certified	not traded	6.50	19.40	no market	3.00	no market
Government Bonds Long-term, new and old issues, average yield	10.83	12.50	11.37	10.77	14.38	8.00	19.35	7.88	4.22	6.862*
Industrial Bonds prime, long-term, new and old issues, average yield	11.85 As Industrials	13.25	12.66	12.85	15.18	8.10	19.53	8.13	5.73	6.39*
Bank Short-Term Rate (prime rate)	11.00	12.00	12.00	15.50	14.55	9.00	20.75 1/8 qtrly fee on outstg.	7.00	6.50	6.00
Bank Time Deposits 3-month	8.50 Cert. of Dep.	9.80	11.50	12.05	12.75	5.75	11.50	5.00 large deposits	2.00 residents only	3.75
Eurocurrencies 3-month, asked	9.1875	10.625	11.625	no market	19.25	n. a.	no market	5.00	2.75	6.563
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8104	1.5480	.0212	.1465	.4155	.0007	.3776	.5074	.0042
Forward Exchange Cover** 3-month, in percent p.a. D = discount, P = premium	—	1.187 D	2.080 D	4.303 D	9.386 D	3.706 P	11.204 D	4.187 P	6.391 P	2.464 P

Eurodollar Deposits (London, interbank, bid) January 27 7-day 8.8125 1-month 9.0625 3-month 9.3125 6-month 9.5000	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills —.621 U.S.-Canada Treasury Bills +.300 U.S.-Canada Finance Co. Paper +.069 Eurodollars-U.K. Local Auth. Deposits +.108	Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 10.625 Over 7 yrs. 11.00 DM Bonds 7 yrs. and under 7.50 Over 7 yrs. 7.75	Gold Price London afternoon fixing 486.50 (per fine ounce)
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
 *Bond yields as of January 14. **Forward exchange cover as of January 27.

Movements of major currencies against the dollar



*monthly average of daily figures, foreign currency units per U.S. dollar

Currency Substitution and the Canadian Dollar

The November announcement by Canadian central bank officials that they would no longer focus on the monetary aggregates as principal policy variables provided further evidence of the close links between the Canadian and U.S. economies. Since last October it has been apparent that the Federal Reserve has abandoned aggregates targeting, although as yet there has been no official word that the policy shift is a permanent one. With its action, the Canadian government acknowledged once again how difficult—if not impossible—it is for Canada to maintain a monetary policy independent of the United States. Efforts to do so in the past for anything more than a short period of time have been answered by the foreign-exchange markets with sharp swings in the value of the Canadian dollar.

One force behind this convergence of policies is the high degree of substitutability between the U.S. and Canadian currencies—that is, the extent to which corporations, banks, and individuals hold both Canadian dollars and U.S. dollars in their money portfolios in order to conduct their daily business. A close relationship between the currencies has evolved over the years, owing to a number of special conditions: The capital and product markets of the two countries are well integrated; both currencies are used in Canada and along the northern tier of the United States; and finally, the monetary and political authorities of both countries function in much the same way.

Chase research has found that taking account of this substitutability can lend a good deal of predictability to Canadian exchange-rate movements. Any change in the relative proportions of the two currencies that businesses and individuals hold in their money portfolios must affect the Canadian dollar/U.S. dollar exchange rate. Somewhat surprisingly, however, many of the traditional approaches to exchange-rate analysis either overlook currency substitution entirely or include non-substitutability as a basic assumption.

Traditional models

For example, under the classic theory of purchasing power parity (PPP), movements in the rate of exchange between the currencies of any two countries are driven by relative movements in their respective price levels—but, it is assumed that the citizens of each country hold only their own currency. Divergent price levels, in turn, are caused by differences in relative monetary growth or in the expansion of real output, among other things. In general, according to PPP, the country experiencing greater money growth can be expected to suffer a depreciation of its currency. The currency of the country with relatively

stronger real-output growth, on the other hand, is more likely to appreciate, because the higher level of economic activity can support increased money growth without inflationary pressures.

Traditionally, PPP has been accepted as a guide to long-run exchange-rate trends, but it has been criticized for its limited usefulness in short-run forecasting. PPP models typically have no way of accounting for the uncertainties spurred by government exchange-market intervention or for the variable effects on the spot exchange market of delays in the commodity-arbitrage process.

Another type of foreign-exchange analysis—the balance-of-trade approach—explains exchange-rate movements through the balancing of receipts and payments in international trade. A direct relationship is assumed between the trade balance and the exchange rate. Balance-of-trade deficits call for a depreciation of the domestic currency to inhibit imports and make domestically produced goods more competitive in world markets. These methods take into account such “nominal” (unadjusted for inflation) forces as relative price levels and interest rates, but ignore the impact of capital flows on balancing accounts. They share with PPP the exclusion of currency substitution as a determinant of exchange-rate movement.

A third approach to exchange-rate determination, the monetary approach, has gained a great deal of support in recent years because it has the positive attribute of considering both nominal and real (inflation-adjusted) variables. In general, this method begins with an assumption of purchasing-power parity. The balance between domestic money supply and demand determines prices. Real income and nominal interest rates, in turn, determine money demand. Thus, under this approach, exchange-rate movements are driven by relative changes in money supply, interest rates, and real income.

Under floating exchange rates, the standard monetary model assumes zero currency substitution. Demand-side substitutability is generally dismissed with an assumption that individuals desire money portfolios consisting entirely of domestic currency. Any foreign currency or foreign asset denominated in a foreign currency is therefore immediately exchanged for its domestic counterpart. Such an assumption, of course, is unrealistic in view of the high degree of integration between the U.S. and Canadian financial markets—which may explain why this approach has not done very well in explaining movements in the C\$/US\$ exchange rate.

Going to the opposite extreme would incorporate the monetary approach using an assumption of perfect

Currency Substitution and the Canadian Dollar *(continued from page 7)*

demand-side substitutability—that is, a case in which businesses and individuals are totally indifferent as to whether they hold Canadian dollars or U.S. dollars, because either is equally capable of providing the money services they require.

Because there would exist foreign demanders of domestic currency, a decision by the monetary authorities of one country to increase domestic money supply would have international effects. Some of the increase would find its way into the portfolios of foreign holders of domestic currency, increasing the foreign money stock and price levels accordingly. In the absence of government intervention in the foreign-exchange markets, inflation would be transmitted between countries. Furthermore, the ability of the monetary authorities to pursue autonomous domestic policies would be totally undermined.

Applying this framework to the United States and Canada would be tantamount to identifying the total money stock of the two economies as the relevant money variable in explaining prices and thus foreign-exchange movements. There would be one inflation rate common to both countries. Of course, the level of real output may differ. To support different rates of output growth would require a divergence in measured velocities of money circulation.

Canada and the United States would thus be considered part of a common capital pool, which both countries must use to support their real economic activity. During periods in which economic activity in Canada exceeds that in the United States, money would tend to flow into Canada from the United States. The rate of growth of Canadian dollars or the proportion of Canadian dollars to the total combined money stock would then be rendered ineffectual with respect to the rate of inflation or real economic activity in Canada.

Although this version of the monetary approach seems to make more sense than the first one examined, which assumed no substitution between U.S. and Canadian dollars, empirical testing of a model incorporating the logic and assumptions of *perfect* currency substitution is academic, since it is obvious that the spot exchange rates for U.S. and Canadian dollars can and do diverge.

A third variation of the monetary approach—using imperfect substitutability between the two currencies—not only has intuitive appeal, but also yielded extremely good results when tested. The scope for currency substitution depends on the extent to which Canadian and U.S. monetary policy diverge. Long-run expectations are for U.S. and Canadian prices to move roughly in the same pattern and for the exchange rate, in general, not to move enough to lead to portfolio realignment unless there is a major shift

in policy. Short-run price and exchange-rate movements may vary from the long-run trend, however.

Third parties

This method can also incorporate the effects of third-party holders of one of the currencies. For example, portfolios of businesses or individuals from a third country—say Germany—contain several currencies, the majority of which will be neither Canadian dollars nor U.S. dollars. External shocks affecting the German mark/U.S. dollar rate would cause a change in the quantities of U.S. dollars Germans would desire to hold in their currency portfolios. Even in the absence of any change in the degree of monetary-policy divergence between the United States and Canada or other political disturbances, the C\$/US\$ rate might still be affected.

Consider an example in which an external shock affects the DM/US\$ rate, causing holders of marks to sell U.S. dollars. Unless the holders of Canadian dollars desire to hold this extra supply of U.S. dollars, the Canadian dollar would change in value. Traditional approaches would predict a decline in the C\$/US\$ rate resulting from the increased supply of U.S. dollars. But allowing for the substitutability between currencies, the result may be that holders of portfolios sell equal amounts of Canadian dollars and U.S. dollars. An excess supply of Canadian dollars relative to U.S. dollars is thereby created. Consequently, exchange-rate movement may occur merely because of the relative size of the two stocks of money. The more substitutable the currencies, the greater the likelihood of this result.

Obviously, the main conclusion from this exercise is that forecasters who do not consider currency substitution when analyzing the relationship between the U.S. and Canadian dollars are overlooking potentially important information. Second, and more important for citizens of Canada, an independent Canadian monetary policy is difficult, if not impossible, to maintain, unless huge costs are imposed to make Canadian dollars less substitutable for U.S. dollars—costs that consumers will ultimately have to bear.

The policy implications are straightforward. Unless Canadian monetary policymakers are willing to ignore the consequences of international market pressures, they must consider the implications of the current U.S. monetary stance before initiating any set of policies that might be perceived as a *permanent* change in the relationship between the two currencies. The financial markets will be acting on information that changes the degree of currency substitutability—that is, information important to determining long-run policies and activities—rather than information that is simply concerned with the level of Canadian M1 next week.

Terry Wiginton

B1900-1 2/18/83

The Dangers of Premature LDC Reflation

Rising optimism about the U.S. recovery and the promise of lower oil prices this year may prompt a number of non-oil LDCs to take a second look at how efforts to improve their current-account balances measure up against other economic priorities.

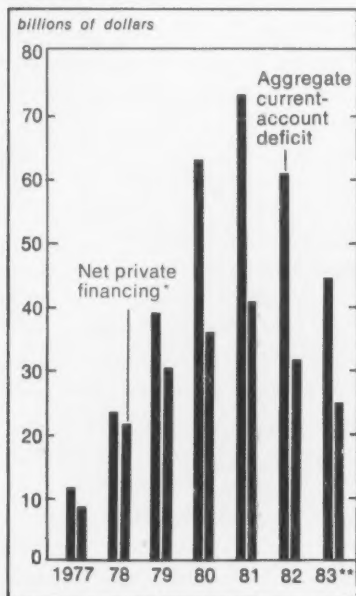
Last year, despite depressed commodity prices, stagnant world trade, and high interest rates, the aggregate current-account deficit of the non-oil LDCs fell some \$10-12 billion below the level of 1981. Much of this adjustment, of course, was involuntary, as constraints on external financing depressed domestic expenditures in many countries. This year, the combination of rising commodity prices, lower interest rates, and a modest recovery in OECD economic activity could trim that current-account deficit by another \$8-10 billion. And a 10%-15% decline in world oil prices this spring could mean an additional \$10 billion improvement through still-lower interest rates and higher OECD imports of raw materials and manufactured goods.

As such improvements appear, there will be intense domestic pressure in many countries to abandon current austerity policies and catch the wave of global recovery. Under such circumstances, are there still dangers of domestic reflation in those non-oil LDCs with relatively large external debts?

Many of the developed countries already know the answer. The OECD nations learned the consequences of "premature" reflation last year—through the discipline imposed by the foreign-exchange and long-term capital markets. In the case of the non-oil LDCs, the taskmasters would include the international banking community and, in the most critical cases, the International Monetary Fund. For, although net private financing of non-oil LDC deficits fell in 1982 (both in absolute amount and as a proportion of total external financing), the decline would have been even more abrupt without collective action to sustain lending to various large debtors. Furthermore, the international capital markets are also likely to be tapped for funds this year by certain oil-exporting countries without the large external reserves of the Arab Gulf states.

Thus, adjustment policies by developing countries—both non-oil and oil-exporting—will remain under scrutiny by the world financial markets during 1983. And a significant improvement in balance sheets will be necessary before international lenders welcome increased expenditures by the non-oil LDCs. After rebuilding reserves, a shift toward expansionary policies would be warranted in 1984.

Financing requirements of the non-oil developing countries



* Including direct investment and net commercial banking flows, both long and short term.

** Forecast

*Lower oil prices
could give strong boost
to German current-
account surplus.*

*Restrictive policies
should yield Belgium
further improvement
in trade balance.*

*Aborted wage bargaining
puts gains of Sweden's
October devaluation
at risk.*

*Papua New Guinea
to place more emphasis
on private sector.*

Germany's current account registered a dramatic turnaround last year—to a 7.5-billion DM surplus, after a 16.7-billion DM deficit in 1981. The trade surplus almost doubled to 51 billion DM and the traditional deficit on invisible items, such as insurance, tourism, and transfer payments, declined somewhat. Ironically, export volume, which rose dramatically in 1981, fell throughout most of 1982, but import volume declined even faster. However, the major force behind the current-account reversal was 4.4% improvement in Germany's terms of trade, as the trade-weighted value of the mark rose and commodity prices in foreign-currency terms declined sharply. A further rise in the ratio of export volume relative to import volume is unlikely this year, but additional improvements in the terms of trade—brought on by, among other things, a lower oil price—could lead to a doubling of the current-account surplus. For example, a 10% reduction in the DM price of oil, would add about 7 billion DM to Germany's trade surplus.

The tough policies introduced one year ago by Belgium's right-of-center coalition government are showing their first positive effects. A year ago, the franc was devalued by 8.5%, and wage indexation was loosened. This resulted in a reduction of about 3% in real wages and a rise in exporters' profit margins. By the third quarter of 1982, export volume showed year-on-year growth of some 1.6% while import volume was down 7.6%. The trade deficit contracted sharply over the course of the year, so that the September-November period showed a trade surplus of some 8 billion francs, compared with a year-earlier deficit of some 17 billion francs. Industrial production has also shown signs of recovery; latest data indicate output in October was some 3.4% above its year-earlier level. This year, the Martens government is aiming for a further 3% cut in real wages, which—combined with some improvement in the Belgian terms of trade—should lead to a further narrowing of the trade gap.

The recent breakdown of Sweden's centralized wage negotiations is threatening to undo the government's strategy for improving international competitiveness and encouraging export-led growth. The government's fiscal 1983/84 budget proposals, announced last month, are clearly designed to reinforce the positive effects of last October's 16% devaluation. Proposed programs focus on curbing domestic demand for imported goods by stemming private consumption and on boosting employment via export growth and stepped-up spending for public- and private-sector investment. But unless Swedish wage increases can be kept in check, the benefits of devaluation will be lost to increased inflation, and the country's export performance and current-account deficit will remain as troublesome as ever. Swedish inflation has persistently been higher than that of its trading partners and has already shown signs of accelerating further. December's 10% year-on-year increase in consumer prices was the largest rise since November 1981. Prime Minister Palme has appealed to both labor and management to remember their "responsibility to the citizens of Sweden" and is expected to exert strong pressures on both sides to get back to the bargaining table.

The economy of Papua New Guinea was disrupted last year by weak demand for cocoa, copra, coffee, and most important, copper. As a result, the government has reconsidered its development priorities. Prime Minister Somare recently indicated what may be a major shift in policy, eschewing the development path followed since independence in 1975. According to Somare, that path centered on excessive government spending and involvement in most development projects—policies which have now proven to be "inappropriate" for Papua New Guinea. The prime minister envisions a smaller government sector, and as a result, about 10% of the public workforce will be cut. New emphasis will be placed on agriculture in hopes that the country can become self-sufficient in food production. Somare, a well-respected Third-World leader, now seems to believe that more dependence on the private sector will produce faster growth than the highly-centralized planning that characterizes many developing economies.

*Canadian economy
showing signs that
it is on the mend.*

Signs of an incipient economic recovery in Canada are becoming more evident. The slowdown in inflation, from over 11% in the second quarter of 1982 to 9.3% at year-end gave a boost to consumer confidence according to Canada's Conference Board, suggesting consumers may be in a better buying mood. In addition, the decline of interest rates has spurred a revival of housing starts. The unemployment rate—which has been above 12% since last August and peaked at 12.8% in December—dropped to 12.4% in January. Not all indicators are positive; business profits and export orders, for example, have yet to confirm that the rebound is unquestionably underway. Nevertheless, with a moderate recovery expected for the U.S. economy, the emerging trends that have already surfaced in Canada suggest a rise in real GNP this year in the neighborhood of 1.5%—a marked turnaround from the 5% decline of 1982.

*Oil price uncertainties
suggest another year
of sluggish growth
for Venezuela.*

The Venezuelan economy grew by a scant 0.4% in real terms last year as petroleum export earnings fell because of both price and volume declines. This represented the fourth consecutive year of sluggish economic activity owing to either policy-determined demand restraints or flagging oil earnings. The drop in 1982 demand prompted a slowdown of inflation but also a rise in the unemployment rate to 7%. Prospects for the economy in 1983 are heavily dependent on the course of international oil prices and Venezuelan output. Petroleum production in the first three weeks of January was at 2.1 million barrels per day—11% higher than the 1982 average rate. But lingering price uncertainties will inevitably affect export earnings this year. The efforts now underway to refinance the short-term portion of Venezuela's \$24 billion public-sector external debt could also add to possible difficulties. In view of these considerations, policy officials appear to be maintaining their restrictive stance of the recent past. This is likely to mean another year of slow economic growth.

*Constraints on
external funding
limit growth
in Bangladesh.*

The external funding constraint will be the critical force governing the performance of the Bangladesh economy over the next several years. The government has largely exhausted its ability to insulate the economy by running down foreign reserves, and economic activity must now adjust to the level of imports that can be financed from aid inflows, export receipts, and private transfers. Given the outlook for these three sources, imports will have to be constrained for some time to come. This will have serious repercussions for domestic growth, particularly in the non-agricultural sectors. In the current fiscal year 1982-83 (which ends June 30), unless unanticipated capital inflows are forthcoming, the government will have to hold imports down some 3.4% below the already depressed level of 1981-82. This is likely to lead to a drop of manufacturing output of about 4%. As a result, despite the likelihood of a modest rebound in agricultural production this fiscal year, real growth is projected to be just 2%.

*Bahrain
rides out
recession.*

For some time Bahrain, with its low and declining oil production, has been preparing itself for a post-petroleum era. In the 1970's it emerged as the service center of the Arab Gulf region and more recently it has been investing heavily in industrial projects based upon its natural gas resources. As a result, Bahrain has so far been able to weather the current oil glut better than some other oil producers. The world recession is taking some toll: Weak demand has forced production cutbacks at both the oil refinery and the aluminum smelter. On the whole, however, domestic economic activity has remained brisk, mainly because a number of new large infrastructural and industrial projects—including the \$560-million 26-kilometer causeway between Bahrain and Saudi Arabia—have commenced construction. Bahrain's strong financial position, appears to have remained intact as oil output from its domestic field and from the Abu Saafah field shared with Saudi Arabia has shown little deviation from previous levels. Meanwhile, Bahrain's offshore banking sector has continued to prosper, with some 68 offshore banking units now licensed. As of the end of 1982's third quarter, their total assets had reached \$59.5 billion—28% above the level a year before.

The 1984 Budget: The More Things Change . . .

The Reagan administration's fiscal 1984 budget proposal repeats many of the themes from its budget proposal for the last fiscal year: promoting economic growth and preserving the gains made in reducing inflation, while at the same time diminishing the magnitude of the deficits. The multi-year tax cuts approved in 1981 are to be preserved, and the planned defense buildup is to remain essentially intact as well. And with economic growth prospects projected to be less sanguine than was expected a year ago, Congress faces yet another round of spending cuts and tax increases to meet the continuing challenge of extremely large deficits.

Many legislators thought that the deficit problem had been adequately addressed by last year's reconciliation bill, which included both expenditure reductions and revenue-raising measures. A year ago, the fiscal-1983 deficit had been projected to be \$146 billion, with deficits in later years averaging \$170 billion if no legislative actions were taken. The administration proposed enough spending cuts and tax increases so that the 1987 gap would narrow to \$53 billion from \$91 billion in 1983. Despite congressional acceptance of about 70% of these proposals, however, the Office of Management and Budget estimates that the 1983 deficit will now be \$207 billion. And the OMB projects that the gap could widen to more than \$300 billion in

1987 unless further spending cuts or tax increases are enacted.

The estimated budget deficits have soared primarily because of a substantial downward revision in economic-growth prospects. Last year's budget projected real growth of 3.0% during 1982 and 5.2% in 1983. But real GNP actually declined 1.2% in 1982, and 1983 growth is forecast to be just 3.1% in the budget. This six-percentage-point difference by year-end 1983 would lead to a reduction of \$69 billion in estimated tax receipts for fiscal 1983. Lower-than-expected inflation would also contribute to this revenue shortfall. Meanwhile, spending estimates have been raised by nearly \$50 billion—in large part because of such recession-induced expenditures as unemployment compensation.

In an effort to maintain control over the budget, the President's 1984 budget proposal aims specifically at trimming the projected 1987 deficit by more than half the OMB projection, to \$142 billion. The centerpiece of the plan is a freeze on overall government spending in real terms. Allowing for inflation, actual expenditures would rise only 5.4% in fiscal 1984. This would come on the heels of spending increases of an estimated 10.5% in fiscal 1983, 10.8% in fiscal 1982, and 14% in fiscal 1981.

Political opposition to the spending restraint is likely to be high, however, particularly because of the extremely uneven impact on different spending categories. For example, a 16% increase in interest outlays and a 14% increase in defense spending are to be offset by halting growth in income security programs and the broad residual category that encompasses all other federal programs.

Although overall spending is proposed to increase slightly faster in later years, the budget recommends maintaining the same pattern of relative rates of increase. Thus, by 1988, the share of government spending going for defense would rise to 34.2% from 25.7% in fiscal 1982, while the income-security share would fall to 27.5% from 30.4%. The interest burden would remain steady, while the budget share for all other items would fall to 26.4% from 32.3%.

In light of the relatively pessimistic economic assumptions used in the budget, the actual performance of the economy will be a key influence on the fate of the President's proposals. If growth indeed turns out to be as slow as the administration projects, Congress might be reluctant to go along with the proposed restraint of spending. Sentiment is already building to increase spending on some direct job-related measures, such as training programs. The President himself has proposed an additional six months of extended unemployment benefits.

On the other hand, a more rapidly improving economy would ease some of the pressure both to stimulate the economy and to reduce the deficit. For

example, if real growth should rise 5% this year rather than the projected 3%, the fiscal 1983 deficit would fall by about \$30 billion to \$150 billion, with even greater improvement in fiscal 1984.

Of course, there are less-pleasant surprises that could enlarge the deficit. For example, falling oil prices would reduce revenues from the windfall-profits tax and the oil-rights leasing program. Or another year of bumper crops could drive up the cost of agricultural subsidies.

Especially facing such risks, a stronger economy would be a more welcome way of reducing the deficits than the spending curbs and tax increases that have been proposed so far. The consensus of private forecasters seems to be shifting toward the view that this faster growth will indeed occur. Even with six years of uninterrupted growth averaging 4% per year, however, the fiscal 1988 deficit would remain over \$100 billion. Unemployment is then projected to be down to 6.2%—the lowest rate of unemployment the administration thinks is attainable without inflation pressures reemerging.

While deficits of this magnitude in the context of a prolonged recession are not necessarily inflationary, the prospect of such a large budget gap when the economy's resources are nearer full-employment levels is clearly disturbing to many credit-market participants—and to governors of the Federal Reserve Board. Since the Reagan administration seems content with stabilizing inflation in the 4%-5% range, the burden of any further progress in the anti-inflation fight has fallen on the shoulders of the Fed. *Douglas L. Bendt*

Asia and Oceania Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS							MONEY AND BANKING							COUNTRIES
		6 months ending	12-month change	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars February 9, 1983	change from year earlier	current monetary conditions		
												latest data	consumer prices	latest data	money supply(M1)					
Bangladesh	Government austerity measures depressing nonagricultural activities.	Sept.	+ 3%	10.8*	120	Dec.	183	+ 32%	1.0	413	External resource constraint will necessitate 3.4% cut in FY 1982-83 imports.	Nov.	+ 5%	Sept.	+ 6%	.0408	-20%	Credit demand sluggish; taka depreciation resumed.	Bangladesh	
Burma	Government claims real growth of 7% likely in year ending March 31.	Aug.	-15%	5.8*	159	Dec.	89	- 61%	2.6	79	IMF loan of \$27.9 million received to compensate for export shortfall.	Aug.	+ 8%	Feb.'81	+12%	.1267	- 6%	Exchange rate remains fixed against SDR.	Burma	
China, People's Republic	Industrial growth of 7% and record grain harvest expected in 1982.	Dec.	+ 3%	260.0	260	Sept.	9,444	+140%	6.7	492	Import growth accelerating after record trade surplus of \$4.6 billion in 1982.	Dec.'81	+ 3%	Sept.	+12%	.5120	- 8%	Investment growth to boost deficits in 1983.	China, People's Republic	
Hong Kong	Real GDP will probably grow by a modest 6% this year.	June	+ 7%	24.2	4,695	n. a.	—	—	—	—	Most recent statistics indicate trade deficit narrowing owing to import declines.	Sept.	+ 9%	July	+ 6%	.1508	-12%	Interest rates falling fast.	Hong Kong	
India	Bombay textile strike enters second year.	Aug.	-15%	161.4*	236	July	4,524	- 16%	4.4	2,279	India will be major beneficiary of any reduction in oil prices.	Oct.	+ 7%	April	+ 9%	.1002	- 9%	Credit remains restrictive.	India	
Indonesia	Oil-fueled real growth slows; austerity measures likely.	July	-23%	81.5	541	Dec.	3,145	- 37%	2.5	0	Falling oil revenues hurt current account, putting pressure on rupiah.	Oct.	+ 9%	Aug.	+27%	.0014	-13%	Foreign reserves dropped about \$2 billion in 1982.	Indonesia	
Japan	Economy remains sluggish; still no clear signs of recovery.	Nov.	-13%	1,130.3	9,607	Dec.	23,334	- 17%	2.3	0	Current account surplus of \$6.9 billion recorded in 1982.	Nov.	+ 2%	Oct.	+ 8%	.00419	- 1%	Yen weakness forestalls discount rate cut.	Japan	
Korea	Government projects real growth of 7.55% in 1983, with a 12% rise in exports.	Nov.	+ 1%	62.3	1,610	Dec.	2,807	+ 5%	1.4	1,259	Export growth slowed in 1982; exports only \$22 billion.	Dec.	+ 5%	Oct.	+68%	.0013	-13%	Money supply target 20% this year.	Korea	
Malaysia	Additional fiscal belt-tightening likely.	July	+ 6%	24.0	1,665	Nov.	3,893	- 1%	3.6	274	First LNG shipment left Malaysia for Japan.	Sept.	+ 5%	Oct.	+14%	.4385	- 1%	Budget deficit for 1982 soared to 19% of GNP.	Malaysia	
Pakistan	Real growth around 6% projected in fiscal 1982-83 ending June 30.	Sept.	-13%	30.9*	360	Dec.	969	+ 34%	2.1	1,165	December exports up 32% over year-ago in rupee terms but only 3% in dollars.	Nov.	+ 4%	Oct.	+16%	.0781	-22%	Steel mill will take large chunk of planned credit.	Pakistan	
Philippines	Real growth for 1982 estimated at 2.6%, the lowest rate in 20 years.	Sept.	- 9%	38.6	780	Dec.	1,720	- 22%	2.5	833	3% ad valorem tax, prepayment of customs duties adopted to cut imports.	Oct.	+11%	Oct.	- 1%	.1080	-11%	Ceiling on foreign borrowing trimmed to \$2 billion.	Philippines	
Singapore	Real GDP growth projected to be a sluggish 2%-3% in 1983.	Oct.	0	12.5	5,121	Sept.	7,633†	+ 12%	3.3	0	Exports down owing to world recession.	Nov.	+ 1%	Sept.	+17%	.4803	+ 1%	Interest rates falling steadily since mid-1982.	Singapore	
Sri Lanka	Announcement of 1983 budget awaited, expected to give direction of economic policy.	Oct.	- 6%	4.4	294	Nov.	287	- 5%	2.0	377	Tea prices continue to recover.	Oct.	+ 8%	Sept.	+18%	.0467	- 1%	Mahaweli project pressuring budget, credit expansion.	Sri Lanka	
Taiwan	Recently signed agreement with U.S. will permit modest expansion of textile industry.	Sept.	+ 3%	46.0	2,559	Sept.	7,897	+ 51%	5.1	0	Restrictions on imports of Japanese goods have been lifted.	Sept.	+ 2%	Sept.	+21%	.0141	-51%	Loan rates fell about 400 basis points in 1982.	Taiwan	
Thailand	Central bank puts 1982 real growth at 4.5%, forecasts 5.5% for 1983.	Sept.	- 3%	36.1	750	Dec.	1,538	- 11%	2.1	702	Volume declines in agricultural products will make export gains difficult.	Nov.	+ 4%	June	+ 6%	.0450	- 1%	Rate ceiling on loans cut to 17.5% from 19%.	Thailand	
Australia	Real GDP expected to fall 2% in year ending March 31; drought halved wheat crop.	Sept.	0	158.2	10,648	Dec.	6,371	+281%	2.8	36	Capital inflows in 1982 second half net new record of A\$6.33 billion.	Sept.	+12%	Oct.	- 1%	.9650	-12%	Interest rates fall fast as foreign capital pours in.	Australia	
New Zealand	Further declines in business activity expected before the economy bottoms out.	Oct.	- 1%	23.5	7,510	Dec.	664	- 1%	1.3	3	Exports have fallen because of low demand for agricultural products.	Sept.	+17%	Oct.	+ 2%	.7120	-10%	Interest rates have remained high, bucking world trend.	New Zealand	
Papua New Guinea	Depressed business conditions contribute to government's decision to trim its workforce by 10%.	Sept.	-10%	2.6**	867	Dec.	345	- 24%	3.4	50	Rising copper prices will help to improve the current account.	Sept.	+ 6%	Sept.	- 5%	1.3425	- 6%	Falling Australian interest rates should ease credit conditions.	Papua New Guinea	

*Fiscal year **1980 †includes gold holdings

World Interest Rates

market rates of Feb. 8, 1983; bond yields as of Feb. 4, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.99	11.00 intervention rate	11.50	9.50	6.00	18.00 penalty rate 21.00	4.50	4.50	5.50
Day-to-Day Money	8.375 February 9	9.75	11.00	9.45	12.563	6.00	19.00	5.00	3.00 1-month Euro-Swiss fr. rate	6.688
Treasury Bills 91-day, Middle Rates	8.55	9.55	10.75	12.25	n. a.	n. a.	18.004 78 days	no dealing	no market	n. a.
Commercial Paper prime, 3-month, asked	8.75 finance paper discount basis	9.80 finance paper 15% tax w/h	n. a.	11.40 Certified	13.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	9.75 15% tax w/h	10.875	11.40 Certified	not traded	6.50	19.25	no market	3.1875	no market
Government Bonds Long-term, new and old issues, average yield	11.00	12.41	11.70	10.72	14.39	7.95	19.43	7.89	4.23	7.43
Industrial Bonds prime, long-term, new and old issues, average yield	12.00 Aa Industrials	13.375	12.90	13.20	15.11	8.30	19.27	8.23	5.85	6.39
Bank Short-Term Rate (prime rate)	11.00	12.00	11.00	15.50	14.55	9.00	20.00 1/8 qtrly fee on outstg.	7.00	8.00	6.00
Bank Time Deposits 3-month	8.375 Cert. of Dep.	8.50	11.25	12.15	13.00	6.00	11.50 large deposits	4.875 residents only	2.00 20% tax w/h	4.25
Eurocurrencies 3-month, asked	9.438	10.00	11.313	no market	21.375	5.875	no market	5.00	3.25	6.75
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8164	1.5415	.0209	.1449	.4111	.0007	.3731	.4965	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.441 D	1.583 D	4.221 D	11.318 D	3.503 P	12.80 D	4.503 P	6.284 P	2.554 P
Eurodollar Deposits (London, interbank, bid) February 9	7-day 8.750 1-month 8.875 3-month 9.250 6-month 9.563	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills —0.470 U.S.-Canada Treasury Bills —0.209 U.S.-Canada Finance Co. Paper —0.475 Eurodollars-U.K. Local Auth. Deposits +0.083		Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 11.25 Over 7 yrs. 11.50 DM Bonds 7 yrs. and under 7.75 Over 7 yrs. 8.00		Gold Price London afternoon fixing 497.25 (pe. fine ounce)				

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Dec.) 3.9	(Dec.) 9.3	(Dec.) 5.4	(Dec.) 9.4	(Jan.) 3.9	(Jan.) 16.4	(Dec.) 5.5	(Dec.) 1.8
Industrial production*	(Dec.) -6.1	(Nov.) -11.6	(Nov.) -0.6	(Nov.) -1.5	(Dec.) -4.8	(Nov.) -7.5	(June) -0.7	(Dec.) -0.3
Trade balance† (billions of local currency units)	(Dec.) -\$3.37	(Dec.) C\$1.80	(Dec.) £0.59	(Dec.) -FF5.9	(Dec.) DM6.39	(Dec.) -Lit.1.13	(Dec.) -SF0.23	(Dec.) ¥582.1
Money supply (M1)*	(Dec.) 8.1	(Oct.) 5.4	(Oct.) 18.8	(Aug.) 15.0	(Oct.) 6.5	(Aug.) 13.5	(Oct.) 7.2	(Sept.) 5.0
Velocity of money (M1)*	(Dec.) -8.0	(June) 1.5	(March) -5.1	(June)** 1.2	(June) 1.2	(June)** 7.6	(March)** -5.8	(June) -1.4
Reserves minus gold (\$ million, change from previous month)	(Dec.) -60	(Dec.) 113	(Dec.) -671	(Dec.) 3,182	(Dec.) 1,262	(Dec.) 861	(Dec.) 1,729	(Dec.) 338

* Percent change from 12 months earlier.

** based on GDP.

† Figures are only for the month indicated.

Tough Choices Ahead for Portugal

Portugal is about to be given yet another chance to come up with a political alliance that can deal effectively with its economic problems. Earlier this month, President Eanes—in an effort to fill the political vacuum left by the breakup of the right-of-center Democratic Alliance under Prime Minister Balsemao—dissolved Parliament and called for a general election to be held on April 25.

Whatever the outcome of the election, the winners will be faced with tough decisions on economic policy. Developments over the past two years have caused some of the optimism over Portugal's medium-term growth potential to fade. In general, long-term prospects are still viewed as good—especially given expectations of future membership in the European Economic Community (EEC). But there are growing concerns that without rapid attention to the need for both short-run stabilization measures and fundamental structural reforms, the country's economic potential may not be fully realized.

Portugal had begun a program of economic stabilization in 1977, and by the end of the decade it was starting to show some success, raising hopes that the economic dislocations of the 1974 revolution would soon be history. The election of the Democratic Alliance in 1979 saw a move toward economic liberalization. Under then-Prime Minister Sa Carneiro, the coalition seemed determined to address the country's long-term problems. Since then, however, the Portuguese economy has faltered in the face of the second oil price shock, world recession, and delays in dealing with a number of important economic issues.

A disappointing 1982

Prospects for the economy in 1982 were never bright, but initially there was some promise that the year would at least bring some improvement over 1981's record: The 1982 budget called for reducing the deficit as a proportion of GDP to 8.6% from 11.4% the year before; accordingly the government initiated a hiring freeze and raised expenditure taxes. Reports had indicated that a three-year Extended Fund Facility agreement to provide \$1 billion toward structural improvements had been negotiated with the IMF. The crippling drought of 1981 had finally come to an end. And since a modest world recovery was expected, the authorities anticipated a reduction in the current-account deficit from 1981's \$2.7 billion—an unwieldy 12.4% of GDP—and a moderate rebound from the 1.8% real growth of the previous year.

Policymakers' hopes for the year were never realized. In part, this was due to forces beyond their

control: World trade, including tourism, remained depressed; high interest rates continued to impose a burden; and rainfall increased but was insufficient to refill Portugal's reservoirs.

Some of the responsibility for last year's poor economic performance, nevertheless, stems from domestic sources. The agreement with the IMF that would have imposed corrective measures was not finalized. Furthermore, government finances failed to improve as budgeted. Unofficial estimates place the 1982 deficit at 180 billion escudos—still roughly 10% of GDP. Consumer price inflation by year-end had slowed significantly from its 27.1% peak last March. But at more than 20%, it was still the highest in Europe. Economic growth is estimated to have picked up only slightly, to around 2%.

The government did take some deflationary policy actions. For example, monetary policy was tightened in April and the escudo was devalued by 9.3% in June in an effort to stem import growth. But these measures were insufficient to prevent a further deterioration of Portugal's balance-of-payments position. Export volume in 1982 is estimated to have risen by only 4%, well below the officially forecast 7%. And both worker remittances and tourism receipts—two important sources of foreign exchange—fell below their 1981 levels. As a result, the current-account deficit swelled to around \$3 billion—more than 13% of GDP.

A pivotal year

Portugal's economic condition will become of concern if the current-account deficit is not reduced. The old government had aimed for a reduction in the current-account deficit in 1983 to a still-high, but somewhat more manageable, \$2 billion. However, the current economic environment will not make this easy to achieve. With much of the world—particularly Europe—still in recession, demand for Portuguese exports will not be strong. And without further adjustment of the escudo, the competitiveness of the country's exports will deteriorate still further. Tourism and remittances are likely to be similarly weak. However, debt-servicing costs should decline as the fall in U.S. interest rates will more than offset the effect of any increase in external debt. The crucial question will remain the strength of import demand. Without strong deflationary measures, imports will continue to rise. Renewed expansionary monetary and fiscal policies would almost certainly preclude any substantive near-term improvement in the current-account balance.

To an extent, concerns over the increase in Portugal's current-account deficit have been somewhat

Tough Choices Ahead for Portugal *(continued from page 7)*

overstated. Prior to the revolution, Portugal had virtually no external debt. It thus has had some room for prudent, moderate borrowing. Moreover, as a result of historical developments, the country holds over 22 million ounces of gold in its reserves. This is currently worth some \$11 billion at market prices and largely offsets its stock of debt.

The gold, however, does not generate a flow of income to mitigate the burden of a debt that has to be serviced at market rates. Furthermore, although Portugal's net foreign liabilities are comparatively low, there is a danger that they will grow quite rapidly unless the deficit is sharply reduced. In all likelihood, the success of the new government's efforts to shrink the balance-of-payments gap will be judged as a short-run indicator of its policymaking abilities.

Structural reforms

To fulfill the positive medium-term outlook, the Portuguese authorities must also quickly come to grips with the country's structural problems. Important issues concerning public finance, industrial restructuring, and agricultural reform need to be resolved if high growth rates are to be restored, if the balance of payments is not to be excessively constraining, and if Portugal is to take full advantage of future EEC membership.

At about 10% of GDP, before allowing for the borrowing of public enterprises, Portugal's large government deficit is a continuing drain of economic resources and a generator of inflation. This is of concern because the deficit is, to a large extent, financing consumption expenditures rather than public-sector investment. One of the major causes of the burgeoning budget gap has been the rapid escalation of public subsidies. Cutbacks will be required if the government's financial position is to be improved in order to alleviate Portugal's external-financing constraint.

Furthermore, as long as the public deficit remains large, policymakers will be hard-pressed to bring down inflation significantly. The lack of effective domestic capital markets has meant that the deficit has been financed almost totally by the Bank of Portugal's money creation. For example, in 1981, the needs of the general government and public enterprises accounted for 47% of domestic credit creation. Any attempt to reduce inflation via the control of money or credit will inevitably crowd out private borrowers unless public borrowing requirements are reduced.

The industrial sector needs to perform strongly if Portugal's economic future is to be assured. At present, industry generates some 39% of GDP and 70% of merchandise exports. It has been among the leading sources of growth in the last decade and still has the ability to continue to play this role. But for this to happen, strong actions are required: new products should be introduced; more efficient production techniques must be adopted, particularly in the textile, engineering, ceramic, and footwear sectors; and non-viable plants need to be phased out. Moreover, the government will need to reassess the currently large public investments and subsidization of heavy industries. The most crucial requirement, however, is a reexamination of government price controls and other regulatory measures.

Portuguese agriculture has the reputation of being among the least developed in Europe. Although it suffers from low and sporadic rainfall, the sector's long-term potential offers large output gains from the use of better techniques and more fertilizer.

The medium-term agricultural outlook centers around the EEC. While the future of the Community's Common Agricultural Policy (CAP) is uncertain, it is clear that EEC membership will bring to Portuguese farming a new pricing structure, new institutional support measures, different protection, and a greater access to EEC markets. Cereals and dairy products are likely to be adversely affected, but there are good prospects for tomatoes and other fruits, wines, and forestry products—despite the likelihood of Spanish competition. As a result, Portugal has the ability to benefit from the CAP, although this will require an aggressive response to the opportunities that will be provided. Output structure must be changed, producers' associations must be strengthened, and more government resources must be devoted to extension and agricultural guidance.

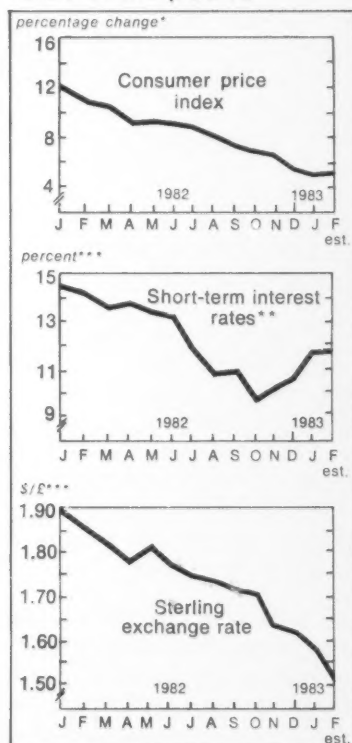
Progress during 1983 will be an important guide to the future of Portugal. The country's low wages and low unit labor costs and its strategic geographical position—along with the ability its exporters have shown in the past to respond to the incentives of new markets and enhanced competitiveness—all argue that the country has good potential for medium-term growth. However, there is a need for the implementation of a strong economic policy that will enable that potential to be realized. The biggest challenge to Portugal's new government will be to act quickly in order to restore the vigorous performance the economy has the ability to achieve.

Peter A. Davies
Chase London

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An Expansionary Budget For the British?

British inflation, interest rates, and the value of the pound



*year over year
**3-month interbank rates
***end of period

If history is any guide to the future, Great Britain will see a giveaway budget on March 15. Unemployment now stands at 12.8% of the work-force while industrial output has fallen almost 12% from 1979's peak to a level not seen since 1975. Most of the constraints that have argued against expansion in the last several budgets have been lifted: At an annual rate, the current account was in surplus to the tune of \$8 billion in the fourth quarter of last year. Furthermore, the year-on-year inflation rate tumbled from 12% in January 1982 to 5.4% at year-end, and with the first two months of 1983 posting rates near 5%, further falls are expected. Even the budget deficit is now under control and at about £8 billion, or 3.2% of GNP, is smaller than the government had aimed for. Political forces also point to an expansionary budget; with a general election widely expected before 1983 is out, the March budget will be the government's last opportunity to present a popular program to the electorate.

Nevertheless, while the elements needed to justify a shift to a more reflationary policy stance clearly have been falling into place, the government's freedom of action has been severely limited by the weakness of the pound sterling. Despite interest-rate hikes last November and again in January, the pound has continued to fall against almost all currencies and, with the oil market in a state of uncertainty, sterling still looks exposed.

Odds are, nonetheless, that the March budget will be strongly expansionary. The Thatcher government will probably argue that much of the recent fall in the pound represents an adjustment to past overvaluation, and—provided that it is reelected—there is little reason for a further selloff. Judged in terms of relative inflation rates, sterling is only about 6% overvalued today. And unless the world price of oil falls so low that Britain's differential advantages as an oil exporter disappear, some degree of overvaluation is to be expected in the future. With the prospect of continuing low inflation and a large—although falling—balance-of-payments surplus, substantial further declines of the pound seem unlikely.

Thus, the government can be expected to inject some £2 billion into the economy, mostly by means of cuts in personal taxation. Without the recent weakness of the pound, cuts in interest rates could also have been expected, but it is now likely that interest rates will be used mainly to influence the exchange rate. As a result, their movement will depend upon the fortunes of sterling.

*Strong budget medicine
for Ireland's
ailing economy.*

Tough policies will have to be kept in place for some time before Ireland's economy can be described as healthy, but there are signs that things are beginning to improve. The new government unveiled a tough budget earlier this month that reflected big tax increases and a reduction in the budget deficit. The deficit is now expected to be roughly £800 million or 7% of GDP in 1983 compared with £988 million in 1982, some 8% of GDP. Higher taxes are expected to lead to a 1% decline in consumer spending this year; GDP growth will probably slow to about 0.5% from 1982's 1.8%. The tax hikes will also add to inflation pressures, although the pre-tax rate of inflation is on a sharp enough downtrend that prices overall are expected to decelerate to about a 14% rate of increase from last year's 17.1%. Despite the stringent budget measures, Ireland's public-sector debt now equals about 45% of GDP, with debt servicing costs totaling some 20% of merchandise export revenue. It is anticipated that the current-account deficit will be reduced to £800 million in 1983 from £1 billion last year. But even this is still large, suggesting a continued need to borrow abroad for the next few years.

*Denmark expected
to maintain
policy restraint.*

The Danish economy is beginning to show the effects of the conservative government's austerity program announced last fall. Industrial production declined in the closing months of 1982 to a level well below that of the previous year, while the inflation indicators showed a significant improvement. Despite some tax increases, consumer prices rose by 10.1% in 1982 compared with 11.7% in 1981, while wholesale prices posted a 10.3% increase compared with 16% in the previous year. Despite some weakness of the kroner during the year, raw material prices rose by 9.9% compared with a huge 27.3% in 1981. However, the country still faces severe problems. Its inflation rate remains higher than those of most of its trading partners and its trade deficit widened in 1982 to Kr 13 billion compared with Kr 10 billion in 1981. This suggests that, despite some reduction in the interest charges on its large overseas borrowings, the current-account balance showed no improvement in 1982 from 1981's Kr 13 billion deficit. As a result, the government is expected to announce further expenditure cuts during the year and also to defend strongly its proposals that wage rises should be limited to 4%.

*Restrictive policies
expected to help
bolster Dutch
current-account surplus.*

The Netherlands' new government has introduced a tough budget for 1983. Spending has been cut 13 billion guilders from previously planned levels, largely via a freeze on public-sector wages and social benefits. In addition, higher personal income taxes are expected to increase revenues over previous plans. The hope is that the public-sector deficit can be held below 10% of national income, rather than nearly 12% if policies are not changed. Over the longer run, the government aims to reduce the deficit to 7.4% of national income by 1986. An incomes policy has also been agreed on for the private sector: wages were raised by only 2% in January in return for a shorter working week—but no reduction in total man-hours. In the short run, these policies will reduce domestic demand. This in turn—combined with Holland's improved international competitive position, lower world oil prices, and a recovery in the rest of Europe—should lead to another rise in the current-account surplus, estimated at some \$5 billion in 1982.

*Singapore awaits
revival of
export markets.*

Despite a recent improvement in domestic interest rates, Singapore's business community is eyeing the prospects for a revival of economic activity with caution. The economy has suffered a severe slowdown in export growth. And because of a paucity of export orders, utilization of the country's productive capacity has continued to deteriorate. A survey by the Department of Statistics showed that some 64% of those businesses polled felt that conditions will remain depressed through the first half of 1983. Official government forecasts seem to concur. Prime Minister Lee Yuan Yen recently projected a modest 2%-3% real growth for 1983 and warned that businesses may soon be forced to begin laying off workers—despite the existence of a labor shortage just last year.

*Chile seeks
rescheduling
of debt.*

Chile is experiencing serious external payments difficulties. Net International reserves dropped by over \$1 billion from the end of September through January—with nearly half of that occurring in the last month—and they continue to decline. The country's net reserves position stands at approximately \$1 billion, the equivalent of some two months of imports of goods and services. The difficulties incurred in meeting service payments on the total external debt of \$18 billion—\$4.2 billion of which is short-term—has led the authorities to seek a rescheduling of the approximately \$4 billion in maturities owed to commercial banks coming due in 1983-84. While discussions are underway, a 90-day standstill on principal payments due on all debt (except short-term, trade-related) has been arranged.

*Argentina on
the slow road
to recovery.*

Argentina is making continued progress in climbing out of two successive years of economic decline. Manufacturing output turned up sharply in the final quarter of 1982, after nearly three years of stagnation. In addition, an excellent harvest is promising record grain exports, while a unified and flexible exchange-rate policy should boost industrial goods. Furthermore, the IMF's approval of a SDR 2 billion program, coupled with the first and second disbursements of a \$1.1 billion commercial-bank bridge loan, has bolstered confidence in Argentina's access to international financial sources. Despite these gains, the country is still struggling to cope with an inflation rate that reached 209.7% at year-end 1982. In part, this upsurge was due to corrective adjustments of public sector tariffs and prices. At the same time, however, an improvement in inflation expectations hinges on the success of the government's efforts to reduce the fiscal deficit as a percentage of GDP—from 14% in 1982 to 5% by March 1984.

*Modest growth
slowdown ahead
for Pakistan.*

Pakistan is expected to record real growth of around 6% in fiscal 1982-83 ending June 30, about the same as the 6.3% growth of 1981-82. Assuming favorable weather, a recovery in the wheat crop is expected to push agricultural production up 5% or better, in contrast to last year's increase of only 3%. But this is likely to be offset by a slowing of industrial growth to around 8%-9% from 1981-82's rapid 12% rate. The outlook for 1983-84 and beyond is more problematic. Growth is likely to be lower than the 6%-plus rate of recent years. The recent trend in agricultural growth of 4% per year will be difficult to sustain without significant success in raising crop yields. In addition, the boost to industrial productivity provided by new capacity additions will begin to taper off once the Karachi steel mill is completed, although deregulation could provide a powerful shot in the arm to domestic industry. Finally, once the IMF's Extended Fund Facility program comes to an end in November 1983, Pakistan's ability to finance its balance-of-payments funding gap may restrain growth. Real growth of 5.5% is possible in 1983-84, but growth thereafter could fall to the 4.5%-5.5% range.

*Gabon current account
expected to
remain in surplus.*

Gabon's oil-dominated economy experienced a number of favorable developments last year including improved oil production prospects, a balanced budget despite substantial growth of investment expenditure, a continued surplus on the overall balance of payments, and rising net foreign assets. The external debt was reduced for the third straight year and is expected to bring 1983 debt-service obligations below 10% of foreign exchange receipts. Nevertheless, economic growth stagnated in 1982 because of weakness in the non-petroleum sectors where diversification so far has remained an elusive goal. Any pickup in growth this year will depend on the strength of the rebound in Gabon's export markets. Allowing for a \$3.50-per-barrel fall to \$31 in the average price of Gabon's 7 million tons of oil exports, the 1983 current account should still show a comfortable surplus. While the overall balance of payments is likely to swing into deficit, an ample reserve cushion could easily finance the gap. But in view of the excessive dependence on oil earnings—80% of total exports in recent years—sharp variations in the price of oil will remain the critical element in the country's external accounts over the medium term.

Oil States Hit by Sagging Prices

The petroleum-rich regions of the United States that have prospered from the spectacular rise in energy prices over the last decade are now beginning to feel the effects of softer oil markets. For states such as Alaska, Louisiana, Oklahoma, and Texas—which hold a dominant share of U.S. petroleum and natural gas resources—the gains in economic activity, personal income, and tax revenues from the production, processing, and transport of state oil and gas deposits are tapering off, if not evaporating. Consequently, just as their Northeast and Midwest counterparts had to do a few years back, these oil and gas states are being forced to adjust to a changing order.

Because the governments of the petroleum-producing states have become so dependent on energy-related revenues, they are particularly sensitive to shifting conditions in the oil market. Tax and royalty income from natural resources in these four states—most of it from oil and gas—totaled \$37.7 billion from 1973 to 1982. Direct oil and gas tax receipts, according to latest available data, rose to \$5.8 billion in 1981 from only \$644 million in 1972. As a percentage of the total 1981 state and local tax take, these direct taxes on production came to 80% for Alaska, 20% for Louisiana, 20% for Oklahoma, and 16% for Texas. Reported rent and royalty income in these states for 1981 was \$2.9 billion. These revenues have gone far, not only to

finance public expenditures, but also to provide tax relief both to households and to businesses not associated with oil and gas production.

Because of reduced energy demand in general, and continued uncertainty over oil prices in particular, these revenues will be sharply curtailed—and at a time when many state and local governments can least afford it. Budgets are already strained by the effects of the prolonged recession and the Reagan administration's attempts to reduce the involvement of the federal government in local affairs. To meet potential revenue shortfalls, the oil producing states will now have to tax other sources aggressively or cut spending.

Nevertheless, the fiscal strains are not likely to do severe long-term damage. Most of these governments, rather than devoting increased revenues from oil and gas to significantly higher expenditures, opted instead for general tax relief. Even Alaska, which did increase outlays sharply, reduced taxes and created an oil and gas trust fund at the same time. Moreover, because their overall tax burdens are already well below those of other states, the oil and gas states can easily raise low (or zero) property and income taxes without seriously hurting their local economies or taxpayers. Had these governments followed a policy of using the windfall oil revenues to provide more public goods and services, the situation would be far more difficult.

Vincent Salvo

The Perils of Credit-Watching

With M1—narrowly defined money—behaving unpredictably and the wider measures, M2 and M3, showing unsightly bulges, the Federal Reserve has decided to incorporate an even broader aggregate into its decision-making. Fed Chairman Paul A. Volcker reported in his congressional testimony in mid-February that the Federal Open Market Committee has begun to look at a measure of credit—total domestic non-financial debt—in addition to the more-familiar measures of money growth. He said the FOMC believed that a credit-growth range of 8%-11% would be an "appropriate" expectation for 1983.

Although Volcker stressed that the Fed has not yet elevated this growth range to the status of a "target," he left the door open for such a move, noting that the current period was "experimental." The FOMC, he declared, "does intend to monitor developments with respect to credit closely for what assistance it can provide in judging appropriate responses to developments in the other aggregates." Such an approach—considering credit as well as money growth in formulating monetary policy—has a certain amount of support among critics of monetary targeting. It is doubtful, however, that such a strategy will improve the functioning either of monetary policy or of the economy as a whole. It may even make matters worse.

Proponents point out that there has been a close long-run relationship in the United States between national income and total credit. Thus, they maintain,

the credit measure—combined with a money target—would give the authorities additional signals to indicate the proper direction of policy.

The close relationship between credit and national income in the past, however, does not mean that it will continue in the future or that it will be a useful guide for monetary policy. As Volcker acknowledged in his congressional testimony, "data for such a broad credit aggregate are not yet available monthly, nor are the tools available to influence closely total flows of credit." Moreover, in practice, the Fed would have to target on changes, or net flows, in credit rather than on the existing stock of debt. But these are only loosely correlated with national income growth.

More fundamentally, the switch in strategy fails to consider the nature of the relationship between money and credit. Money is the basic determinant of the level of prices, and the rate of money growth ultimately determines the long-run underlying rate of inflation. Money acts as an eventual constraint on the growth of credit, since money is the primary means of settling debt. But limiting the growth of credit will not necessarily constrain money growth. Moreover, by diverting attention from the monetary aggregates and giving the Fed further justification for relaxing its grip on the money stock, the new focus on credit increases the likelihood that long-run money growth will be less predictable. Consequently, interest rates may be augmented by needless uncertainty premiums.

D. Sykes Wilford

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GDP IN 1982		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes		exchange rate in U.S. dollars February 23, 1983	change from year earlier	current monetary conditions			
												latest data	consumer prices				latest data	money supply(M1)	
Argentina	Good grains harvest and revival of industrial activity promise economic recovery.	Dec.	-18%	130.0	4,594	Oct.	3,073	-12%	7.0	0	IMF approves SDR 2 billion program.	Dec.	+210%	Oct.	+187%	.00002	-82%	"Neutral" interest rate policy being followed.	Argentina
Bahamas	Recent increase in tourist arrivals promises recovery from two years of recession.	Sept.	+8%	1.4	5,600	Dec.	113	+13%	2.6	0	Foreign capital inflows help payments.	Nov.	+4%	Oct.	+9%	par	0	Credit conditions are restrictive.	Bahamas
Barbados	Economic decline provoked by impact of lower earnings from tourism, sugar, and exports.	June	+19%	0.9	3,333	Dec.	121	+21%	2.6	24	IMF program on target.	Oct.	+10%	Oct.	-5%	.4972	0	Reserves slowdown causes money decline.	Barbados
Brazil	Cuts in public spending depressing consumer demand while unemployment is rising.	Dec.	-13%	293.0	2,382	Sept.	4,185	-23%	2.4	550	Cruzeiro devalued by 23%.	Dec.	+102%	Nov.	+70%	.0028	-62%	Government attempting to lower high real interest rates.	Brazil
Chile	GDP declined about 15% in 1982; prospects are for continued deterioration this year.	Dec.	-10%	23.7	2,060	Dec.	1,815	-44%	6.4	6	Negotiations underway to reschedule debt maturing in 1983-84.	Dec.	+21%	Dec.	-8%	.0134	-49%	Liquidity declining.	Chile
Colombia	Government undertaking reforms of financial sector to bolster public confidence.	Sept.	-6%	39.0	1,423	Dec.	3,862	-19%	8.4	0	Non-coffee exports decline.	Dec.	+25%	Nov.	+20%	.0140	-28%	Credit to public sector is reduced.	Colombia
Costa Rica	Economic activity will continue to deteriorate as a result of weak investment activity.	Oct.	-19%	2.8	1,164	Dec.	226	+72%	3.1	93	Slow progress on \$1.4 billion commercial-debt rescheduling.	Sept.	+109%	Nov.	+65%	.0250	-58%	Liquidity is tight.	Costa Rica
Dominican Rep.	Economic activity likely to be curtailed in light of restrictive fiscal and monetary policy.	Nov.	-30%	8.2	1,464	Dec.	129	-43%	1.1	71	Negotiations underway to reschedule debt owed foreign commercial banks.	July	+7%	Oct.	+22%	par	0	Restrictive credit conditions continue.	Dominican Rep.
Ecuador	Softer oil prices and flood damage to export crops depress foreign-exchange outlook.	Dec.	-17%	14.0	1,573	Dec.	304	-52%	1.8	0	Foreign banks offer public-debt refinancing.	Oct.	+21%	June	+18%	.0140	-53%	Credit is extremely restricted.	Ecuador
Guatemala	GDP declined 3.5% in 1982; further deterioration expected this year.	Sept.	-12%	8.4	1,090	Dec.	112	-25%	1.0	105	Exports dropped to \$1.16 bn. in 1982 from \$1.3 bn. in previous year.	Sept.	-1%	Sept.	+8%	par	0	Net foreign assets declining.	Guatemala
Honduras	Government investment in hydroelectricity and paper and pulp complex continues.	Sept.	-17%	2.8	718	Nov.	143	+53%	2.7	104	Imports dropped \$100 million in 1982 to \$1.2 billion.	Sept.	+11%	Sept.	-3%	.5000	0	Monetary policy is tight.	Honduras
Jamaica	Aluminum majors agree to keep Alpart refinery operating, but at half its production capacity.	Oct.	-26%	3.1	1,378	Nov.	85	-45%	0.7	583	United States will buy 1 million tons of bauxite for its strategic stockpile.	Oct.	+6%	Oct.	+47%	.5600	-2%	Monetary policy is restrictive.	Jamaica
Mexico	Real GDP dropped by 0.7% in 1982 as inflation climbed to 98.9% by year-end.	Sept.	+15%	207.0	2,836	July	1,629	-44%	1.3	221	Foreign-exchange cover given for private loan reschedulings.	Dec.	+99%	Sept.	+58%	.0142	-48%	More credit to be channeled to private sector.	Mexico
Panama	Economy growing slowly owing to depressed international markets and domestic restraints.	Sept.	+21%	4.0	2,020	Sept.	100	-18%	0.7	84	Oil pipeline earnings add to revenues.	Oct.	+4%	May	+9%	par	0	International banking sector experiencing good growth.	Panama
Paraguay	Construction slowdown and depressed commodity prices cause record GDP decline in 1982.	Nov.	+8%	5.7	1,691	Nov.	719	-8%	13.2	0	Capital inflows fall as dam projects are finished.	Sept.	+4%	Aug.	-4%	.0079	-4%	Credit is extremely restricted.	Paraguay
Peru	Real GDP rose 0.7% in 1982, reflecting primarily a 2.3% drop in manufacturing activity.	Sept.	+1%	19.8	1,053	June	1,444	+19%	5.4	571	Preliminary estimates put total external debt at \$11.2 billion.	July	+62%	April	+46%	.00098	-52%	Monetary stance is restrictive.	Peru
Uruguay	Economic stabilization program implemented in context of an IMF standby arrangement.	Aug.	-29%	9.4	3,240	Oct.	229	-37%	2.3	96	New tariffs on imports range from 10%-55%; previous maximum was 75%.	Sept.	+15%	June	-6%	.0323	-63%	Reserve requirements raised.	Uruguay
Venezuela	Slight 0.4% real GDP growth achieved in 1982 despite 10% oil output drop.	Dec.	-20%	73.0	4,966	Dec.	6,579	-19%	6.1	0	Refinancing of public short-term debt planned; exchange controls set.	Oct.	+9%	Aug.	+6%	.2328	0	Interest rates high to stem capital flight.	Venezuela

World Interest Rates

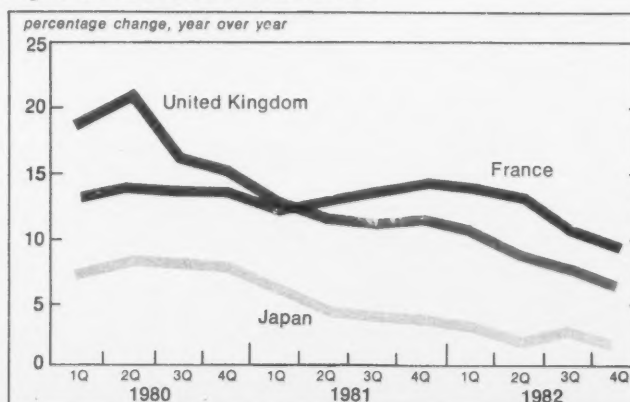
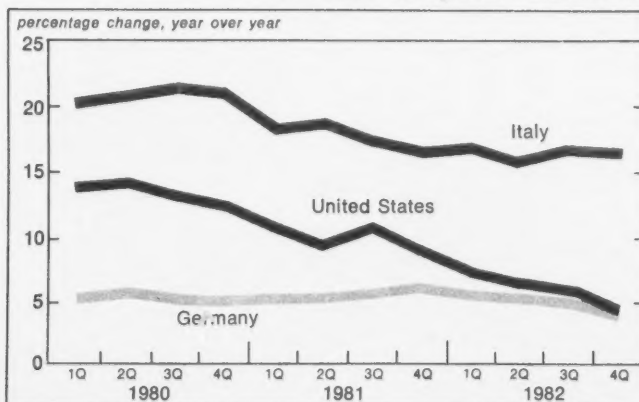
market rates of Feb. 23, 1983; bond yields as of Feb. 18, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.43	11.00 intervention rate	11.50	9.50	5.00	18.00 penalty rate 21.00	4.50	4.50	5.50
Day-to-Day Money	8.375 February 24	12.50	11.00	10.85	12.688	5.50	19.00	5.00	4.375 1-month Euro-Swiss fr. rate	6.375
Treasury Bills 91-day, Middle Rates	7.92	9.20	10.875	12.25	n. a.	n. a.	17.95 93 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.375 finance paper discount basis	9.45 finance paper 15% tax w/h	10.414	11.40 Certified	13.063 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.25	9.35 15% tax w/h	10.937	11.40 Certified	not traded	6.30	19.25	no market	3.125	no market
Government Bonds Long-term, new and old issues, average yield	10.87	12.00	10.91	10.63	14.30	8.00	19.07	7.74	4.24	8.09
Industrial Bonds prime, long-term, new and old issues, average yield	11.70 Aa Industrials	13.00	12.64	12.77	15.04	8.20	19.26	8.07	5.765	6.41
Bank Short-Term Rate (prime rate)	11.00	11.50	11.00	15.50	14.55	9.00	20.00 1/4 qtrly fee on outstg.	7.00	7.50	6.00
Bank Time Deposits 3-month	8.30 Cert. of Dep.	7.50	11.375	12.05	13.063	5.60	11.50	5.00 large deposits	2.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.0625	9.625	11.5625	no market	22.625	5.5625	no market	4.8125	3.125	6.6875
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8133	1.5175	.0209	.1455	.4126	.0007	.3733	.4913	.0042
Forward Exchange Cover** 3-month, in percent p.a. D = discount, P = premium	—	.541 D	2.530 D	5.213 D	12.646 D	3.490 P	12.308 D	4.179 P	5.943 P	2.353 P

Eurodollar Deposits (London, interbank, bid) February 24 7-day 8.875 1-month 8.875 3-month 9.063 6-month 9.313	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills -0.276 U.S.-Canada Treasury Bills -0.409 U.S.-Canada Finance Co. Paper -0.404 Eurodollars-U.K. Local Auth. Deposits +0.280	Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 10.375 Over 7 yrs. 11.00 DM Bonds 7 yrs. and under 7.00 Over 7 yrs. 7.25	Gold Price London afternoon fixing 470.25 (per fine ounce)
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Consumer price trends in major industrial countries



Weighing the Fed's Policy Options

The following is adapted from the statement of J. Richard Zecher, Chief Economist of The Chase Manhattan Bank, before the Senate Committee on Banking, Housing, and Urban Affairs on February 18.

Monetary policy has gone through three distinct regimes since World War II. The first began shortly after the war and had, as a centerpiece, the fixing of the dollar in terms of gold and the fixing of many other currencies in terms of the dollar. This period, from the late 1940s to the late 1960s, was characterized by relatively low inflation and interest rates and by a relatively rapid expansion in economic activity. The second monetary regime was marked by the severance of the dollar from gold in 1973, and by the two oil-price shocks of the middle and late 1970s. This period experienced considerably higher average levels of money growth, inflation, and interest rates than were common during the earlier regime. By 1979, the developing trends for money growth, inflation, and interest rates—and the associated decline in the international value of the dollar—forced a change to a third regime.

The third monetary regime extended roughly from October 1979 to about midyear 1982. A commitment to reduce growth rates in the monetary aggregates, and to reverse the accelerating inflation of the 1970s, was made in 1979 and carried out in large measure during the period extending to last summer. However, the implementation of this policy was far from smooth, intensifying the volatility in interest rates and the extended period of slack in the economy that was expected to accompany disinflation.

For a variety of reasons, money growth since last summer has been very rapid, leaving the Federal Reserve faced with two choices: (a) accommodate this rapid expansion by generating the required growth in the monetary base or (b) apply the monetary brakes again, slowing growth in the aggregates but in the process causing another interest-rate cycle. The Fed chose in this case to abandon aggregates targeting, ending the third monetary regime since the War.

The question now is what policy regime will replace the old one. Will monetary policy drift back toward the interest-rate targeting that led to the crises of the late 1970s? Will it return to a modified aggregates policy that eliminates some of the worst implementation problems of the 1979-82 period, but retains the critical long-term commitment to low inflation through low money-growth rates? Or will it simply drift?

In October 1979, the Federal Reserve initiated a monetary policy designed to reduce the rate of inflation in the United States. The policy was supposedly a "monetarist" strategy, that is, a policy designed to set and adhere to targets for long-term money growth. Thus, the Fed could pursue an aggregates targeting policy, allow

for wider fluctuations in short-term interest rates, and curb the inflation rate—providing eventually lower interest rates with stable nominal income growth.

The policy was stated to be monetarist, but its implementation did not please the monetarists. The methods used to target the aggregates were those developed under interest-rate targeting. Consequently, during 1979-82, the strategy achieved neither its goal of minimizing the fluctuations of money growth nor its goal of minimizing the fluctuations in nominal income. But it *did* achieve its goal of stemming inflation.

The abandonment of the October 1979 experiment in late 1982 may mean an end to the process of disinflation. Under current Fed operating procedures, the rapid decline in interest rates experienced last summer guaranteed that there would be a rapid rise in money growth that would eventually pierce the upper target. A major question was whether the authorities would respond to above-target money growth by tightening monetary policy. Recent experience indicates that the answer, so far, is no. But how long they will be able to ignore the rapid rate of money growth, should it continue, remains an unanswered question.

The view that money growth may be very moderate in the coming months is, fortunately, more than just wishful thinking. Given the Fed's operating procedures, a period of very slow money growth is, in fact, highly likely. Three transient influences explain most of the rapid growth in money since last summer. The first—the rapid decline in interest rates and the Fed's response—ran its course by December. The other two, involving the introduction of bank money-market and super-N.O.W. accounts, have caused distortions in the monetary aggregates that we believe will be largely dissipated by the end of February. Of course, if this analysis proves wrong and the aggregates continue to grow rapidly, inflation will once again return to the center stage of our concerns.

Alternative courses

Having abandoned monetary targets in the last half of 1982, the Federal Reserve is now perceived by many to be adrift. The problem is that there now is no guide for evaluating long-run Fed policy. Under aggregates targeting, one knew something about the long run, even if there remained tremendous uncertainties about the short run. Today we have the opposite problem. We have short-run stability in financial markets relative to recent experience but greatly increased uncertainty about the long run.

Weighing the Fed's Policy Options *(continued from page 7)*

The recent behavior of the monetary aggregates is consistent with several possible courses the Fed may have chosen to pursue. The market is now attempting to judge which strategy will eventually be followed. At least three interpretations are feasible. First, money growth and the behavior of both short- and long-term interest rates have been consistent with a monetary-aggregates policy predicated upon the belief that inflation is under long-run control. In this view, inflation expectations have fallen sufficiently to allow the level of the money stock to increase once and for all, for the temporary reasons detailed above. After a period of adjustment, a new set of aggregates would be announced and a continuation of the earlier aggregates policy could be reinstituted. Second, the recent rise in the stock of money—including the monetary base—is consistent with an interest-rate targeting policy that may or may not prove to be inflationary. And third, the recent experience is perfectly consistent with no policy at all—that is, with a monetary authority adrift, searching for direction after abandoning an approach that was proving to be too costly.

Beginning with the last interpretation first, there is a danger that this view of a floundering Federal Reserve may become the accepted wisdom of the market. Such a course for the Fed—one dictated by fears of Congress, of the White House, or of other political constituencies—would open the economy to a multitude of problems. With the authorities adrift, it is possible that the investing and saving public would have to deal with uncertainties large enough to abort the incipient recovery and trigger another recession.

If the second interpretation—that the Fed has returned to interest-rate targeting—proves to be correct, it could prove to be inflationary, deflationary, or neither, depending on how it is handled. In either case, the policy does not lend itself to predictable results beyond the immediate period.

The first course—a return to some type of aggregates targeting—appears to be the only logical long-run strategy for the Fed to pursue. The system needs to be firmly anchored by a credible Federal Reserve anti-inflationary policy. The markets must have information about the long-run direction of policy in order to make long-term investment decisions. This does not mean a return to the experiences of the October 1979–October 1982 period, but it does mean an assurance to the public that an aggregates-targeting policy is being adhered to in the long run.

Because of the fragile state of the incipient economic recovery, the choice of a proper course for monetary policy is now of the utmost importance. In 1979 there were two major shocks to the world economy: a shift to disinflationary policies and a dramatic increase in oil prices. Both contributed much to the past three years of stagnation in the U.S. and global economies.

The oil-price increase has had a more-permanent effect on U.S. economic activity, lowering our long-run potential real growth path by reducing the economic efficiency of our capital stock and our workers.

Nevertheless, there are growing signs that the economy at last is beginning to pull out of the recessionary period of the past three years. Our reading of the current indicators of economic activity suggests that this quarter should show positive economic growth, and that the prospects are good for real GNP growth of 4% or more between the fourth quarter of 1982 and the fourth quarter of 1983.

Forecasting risks

There is one big *positive* risk to this forecast. We may now be seeing that the oil-price shock was a temporary phenomenon. The large and rapid responses of industry and consumers to the relative-price shifts may have been sufficient to ensure that relative oil prices in the United States during the 1980s will be similar to those of the pre-1979 shock. If this is the case, then we may be underestimating the U.S. potential-output path. The dynamic readjustment to a higher potential output would mean that 1983 and 1984 taken together could be a period of very strong real growth, compared with past recoveries from recessions.

On the other hand, the *negative* risks to our forecast are larger than the risks of underestimating real growth. First, as noted earlier, there is a great deal of uncertainty about the course of monetary policy. A major risk is that a reignition of the world's economic engine could result in a coordinated acceleration of inflation, much as the policies of 1980–82 resulted in a coordinated disinflation. This would lead eventually to a rise in interest rates—both nominal and real—from their already high levels, and depress investment and other interest-sensitive expenditures.

In addition, events of the past four years, particularly disinflation and the oil-price shock, have been as debilitating to governments—in their abilities to manage spending, taxing, and deficits effectively—as they have been to the private side of the global economy. Government deficits are everywhere large, and present serious problems to virtually every national government. The degree of success in regaining control over government spending and borrowing requirements will become increasingly important as the private economy recovers.

Monetary policy is clearly at a crossroads. The economic costs of breaking the inflationary cycle have now been paid in terms of high unemployment and lost output. By reaffirming the principle of aggregates targeting as a long-run strategy, the Federal Reserve can maintain its hard-won credibility and preserve the gains that have been made at so high a sacrifice.

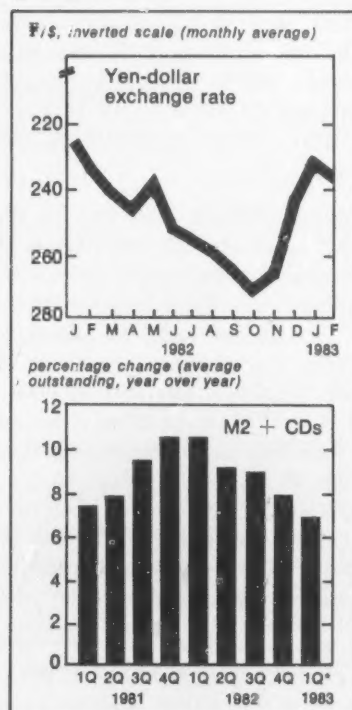
Vol. XVIII, No. 6
March 14, 1983

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1
3/14/83

Policy Changes Spell Stronger Yen Ahead

The value of the yen and Japanese monetary growth



Without fanfare, an important shift in Japanese economic policy appears to be taking place. Over the past year, the government has maintained a restrictive fiscal stance in hopes of eliminating the need to issue deficit-covering national bonds by fiscal 1984. Monetary policy, on the other hand—at least through the first half of 1982—was highly expansionary in an effort to spur weak domestic demand. This resulted in lower real interest rates in Japan than in the United States or Europe, which in turn led to a sizable net outflow of capital, a large loss of reserves, and a sharp depreciation of the yen. The second quarter of 1982 saw a striking improvement in real growth, but all other signs pointed to a continued lackluster economy.

Nevertheless, criticism from the West that the weak yen was giving Japanese exports an “unfair” competitive advantage forced a retreat from the stimulative monetary stance. Beginning last spring, the monetary authorities adopted a progressively less expansionary policy. And although the yen enjoyed a dazzling appreciation from mid-November to mid-January, this tempered policy position appears to have been carried over into 1983. For the first quarter, the Bank of Japan is aiming to keep growth in M2 plus certificates of deposit at an annual rate of just 7%—not a particularly expansionary target, given the likely growth in nominal income and the historically downward trend in velocity.

In addition, Japanese policymakers now appear to be considering a more expansive fiscal policy. The sluggish growth of recent years has forced the government to concede that its goal of balancing the budget by fiscal 1984 cannot realistically be achieved. And because of political considerations, as well as concern about the domestic economy, an income-tax cut has just been promised for fiscal 1983.

Given the government’s persistent problems in selling its national bonds, unless taxes on oil are increased it is difficult to see how income taxes can be cut substantially this year without first laying the groundwork for a new tax to offset the revenue loss. Moreover, although the yen has leveled off for the moment, further appreciation seems inevitable as soon as (a) the oil-price uncertainty subsides and (b) the foreign-exchange market realizes that the United States is likely to pursue a more relaxed monetary policy for several more months. This could spur an easing by the Japanese monetary authorities once again. If, however, the current trend toward a more-stimulative fiscal policy and a less-expansionary monetary policy continues, the yen could strengthen even more than many forecasters are predicting.

*Current-account deficit
a possibility for
Norway in 1983.*

Falling oil prices have prompted further downward revisions of 1983 forecasts for the Norwegian economy. GDP this year is now expected to remain at 1982's level, while the current account is likely to show a small deficit after the series of surpluses enjoyed since 1980. Contrary to its neighbor in the North Sea—the United Kingdom—Norway's currency has not dropped much as oil prices have fallen. Consequently, there is a good chance that domestic inflation will be reduced from its current 10.1% as lower oil prices work through the economy. Reduced oil prices can be expected to lead to declines in Norway's income and its wealth, but estimates suggest that even the country's more expensive fields in terms of production costs would be profitable at a price as low as \$20 per barrel. As a result, Norway should continue to reap a substantial benefit from its oil production. The main issue for the future is the government's reaction to the changed economic situation. For some years, the booming oil sector has tended to overheat the economy. This has generated domestic inflation—11.1% at an annual rate in 1982 on the heels of 1981's 13.6%—and reduced the competitiveness of Norway's traditional industries. The slowdown in the oil sector should provide an opportunity to beat inflation. However, signs are already growing that—following its usual stance of aiming for full, if not over full, employment—the government will introduce countercyclical policies. This suggests that even if inflation moderates somewhat, it will remain high by international standards. It also gives further credence to forecasts of a current-account deficit.

*Falling oil prices
raise hopes for Italy's
current-account balance.*

Italy's 1982 current-account deficit is officially estimated to have declined to \$5.5 billion from over \$8 billion in 1981. Data are not yet available to ascertain how much of the improvement was attributable to volume effects. But preliminary evidence suggests that the bulk of the change was due to an improvement in Italy's terms of trade, as commodity prices fell relative to prices for manufactured goods. The Bank of Italy projects that the deficit will halve in 1983, owing to lower oil prices, lower interest rates on the country's external debt, and slower growth in Italy than in the rest of Europe. If, however, oil prices decline by 20% or more, the improvement could be still greater than forecast: Each 10% fall in oil prices reduces Italy's net oil bill by some \$1.9 billion; even a small surplus is possible. This, in turn, would allow the authorities to follow more expansionary economic policies.

*Greek policymakers
hoping to boost growth,
contain current-account
deficit in 1983.*

Despite some modest gains, 1982 was another difficult year for the Greek economy. Consumer price inflation officially fell to around 20% from 24% in 1981. But according to the latest available data, during the first eleven months of the year, real GDP stagnated while industrial production declined by some 4.5%. The current-account deficit is estimated to have fallen to just under \$2 billion (over 5% of GDP), from \$2.4 billion in 1981. This improvement, however, hides an underlying deterioration—the narrowing of the deficit was entirely due to a rundown of oil stocks that cannot be repeated in 1983. Even more troublesome in the external accounts is the estimated 27% decline in private capital inflows. This forced increased official borrowing but nonetheless led to a \$160-million loss in official reserves. For 1983, policymakers are hoping that the combination of a reflationary fiscal policy, wage and price controls, the recent 15.5% devaluation of the drachma, selective import controls, and a recovery in the rest of Europe will spur stronger GDP growth and help contain the current-account deficit.

*Burma depending on
commodity-price rebound
to turn economy around.*

The Burmese economy faltered last year after four years of rapid advance from 1978 through 1981, during which GDP growth averaged almost 7% per year. GDP growth in 1982 was probably not over 4%, and economic activity may still be slowing down. The country has run into two quite separate problems. For one, it is sharing the world recession and has suffered a setback from serious declines in the prices of its main exports—particularly rice—which normally provide nearly half of total export earnings. Foreign exchange reserves fell to \$89 million last year from \$229 million a year earlier, despite borrowings of

some SDR 25.6 million (about \$28 million) from the IMF's Compensatory Financing Facility. The second problem has been the decline in the output of oil from Burma's only major source—the onshore Mann Field, north of Rangoon. The Burmese government has not yet revealed the extent of the decline, but observers believe that output is now down to around 22,000 b/d from a 1980/81 peak of around 30,000 b/d—a drop on the order of 3 million barrels a year. Shortages of fuel are affecting both transportation and industry. The problem could be resolved by imports, but the government has not yet decided on the course. In any case, imports of the magnitude apparently required would strain the country's limited exchange resources. Offshore exploration by a Japanese consortium may eventually provide new sources of oil and gas, but in the short run, a revival of world commodity prices offers the best hope of relief for Burma's troubles.

Peru's economy did not show the improvement in 1982 the authorities had envisaged when they embarked on an IMF-supported stabilization program at mid-year. Instead of the 60% inflation rate and 4% real growth that had been expected, inflation remained at a rate of 73% for the second year in a row and economic activity stagnated. The current-account deficit was virtually on target at \$1.4 billion, thanks to the poor economic growth, a rapid acceleration in the monthly devaluation rate, and the reimposition of certain import controls. Efforts to meet the fiscal targets that had been set were not so successful, however. Policymakers had aimed to reduce the public-sector deficit to the equivalent of 4.2% of GDP from 8.6% in 1981; it was lowered to only 6.6%. But what is perhaps most disappointing is that Peru technically remained in compliance with the IMF program by resorting to a financing scheme that circumvented the targets established by the Fund to measure fiscal progress. This is unfortunate since a substantial reduction in the budget deficit is crucial to Peru's achieving a sustainable improvement in its external position.

Independent of its position as an oil exporter, Malaysia's stake in stable-to-higher oil prices took on increased importance with the departure of its first liquified natural gas (LNG) shipment to Japan at the end of January. Malaysia now ranks fifth in the world in terms of its deposits of natural gas, with reserves estimated at between 33 trillion and 45 trillion cubic feet. The government is planning to use part of the gas as feedstock for a wide range of development projects but also aims to become a major LNG exporter. Under a 20-year sales agreement signed with the Japanese, Malaysia is committed to shipping 6 million tons of LNG a year to Japan once the production from the major Bintulu plant reaches full capacity in 1985. With the landed price of LNG under the contract tied closely to the average government selling price of crude oil to Japan, the amount of foreign exchange derived from these exports will depend crucially on the behavior of oil prices.

Saudi Arabia's current-account surplus fell markedly last year from 1981's record level of \$45.1 billion. The contraction stemmed from the kingdom's sharp cutbacks in oil output in what proved to be an unsuccessful attempt to defend the OPEC price structure. Saudi production dropped 34% in 1982 to a daily average of 6.45 million b/d, causing a 31% decline in merchandise export revenues to an estimated \$77 billion. At the same time, imports of goods and services rose by about 13% to \$81 billion, and private, as well as official, transfer payments came to about \$9 billion. Taking into account service exports of around \$18 billion—nearly three-fourths of which were foreign investment income—last year's surplus dwindled to an estimated \$5 billion. With the Saudi "marker" oil price—now at \$34 per barrel—set to be cut significantly soon, the country's current account will inevitably move into substantial deficit this year. If the marker price falls by \$5.50 per barrel to \$28.50, if oil output for the year averages 5.5 million b/d, and if imports are held to last year's level, the 1983 deficit will be at least \$15 billion.

Peruvian economic performance in 1982 fell short of most goals.

Malaysia aiming to become major LNG exporter.

Saudi Arabia's current account expected to move into deficit.

Oil, Commodity Prices, and Inflation

The sharp upturn in non-oil commodity prices in the past three months—after an almost continuous drop since late 1980—can be attributed in part to concern that rapid money growth, if sustained, will foster a renewed upsurge of inflation. Fears of an early reacceleration of inflation, however, have been allayed considerably by the intense price-cutting pressure on members of OPEC, helping to moderate any further commodity price increases in the near term.

Historically, commodity prices have been extremely sensitive to the level of economic activity and expectations of changes in the overall price level. Because the supply of many commodities is relatively fixed in the short run, any changes in demand will be quickly translated into price changes. Rising inflation expectations and low or negative real interest rates reinforce the demand for commodities because of expected inventory profits. For example, commodity prices soared more than 25% in 1979 when consumer prices accelerated to an increase of 13.3% and the economy was operating at a high level of capacity utilization.

During 1981-82 all of these forces were reversed. Because of high real interest rates, low overall capacity utilization, and falling inflation expectations, commodity prices tumbled by some 30%.

Although OPEC has attempted to behave like a cartel in setting prices, in the final analysis oil is just

another commodity whose price is eventually responsive to forces of supply and demand. The recession weakened oil demand directly, while the price hikes of 1979-80 led to continuing conservation by oil-importing nations and higher production by non-OPEC members. These forces created surplus capacity within OPEC. With supply not an issue, users felt comfortable with drawing down inventories, aggravating the surplus situation.

It was not until late last year that spot oil prices began their slide. The fact that OPEC was able to resist a downward move in prices as long as it did is one measure of its market power. But OPEC has had difficulty reaching an agreement to restrict output sufficiently to support the official price. Thus, it is likely that oil will continue to be in excess supply for a while, which would impose further downward pressure on its price.

Given the normal time lags between money growth and overall price changes, however, inflation is not likely to be a problem at least until 1984. That could be just the time when the recovery and inventory restocking would sharply increase the demand for oil. OPEC might be able then to regain control over pricing decisions, thus worsening inflation expectations. In that case, the projected moderate price hikes for non-oil commodities would rapidly accelerate.

Douglas L. Bendt

Spotlight Back on M1?

In his March 8 testimony before the House Budget Committee, Federal Reserve Board Chairman Paul Volcker expressed concern that the money supply was growing "somewhat faster" than expected and that such growth might not be "compatible" with progress against inflation over the long-term. The statement was somewhat surprising to Fed-watchers. For although M1 has been growing at a furious pace for months—at a rate of about 14% since August—this is the first indication of official concern over the above-target performance.

Until now, Fed officials have maintained that the rapid growth in money was either technical in origin or the result of unusually strong demand for liquidity on the part of the public. On the first point, policy officials have suggested that the payment of interest on transaction accounts—specifically the "Super-Nows"—would, in all likelihood, result in an overstatement of M1 growth. However, evidence from an as-yet-unreleased Fed survey of banks reportedly suggests this may not be the case. The net effect of deposit flows induced by the introduction of both Super-Nows and the popular money market deposit accounts (MMDAs), apparently has depressed rather than stimulated the growth of M1. Although a portion of Super-Nows—which are accounted for in M1—came from non-M1 sources and did tend to speed M1 growth, the bulk originated from other M1 categories. And the funds flowing out of M1 into MMDAs more than offset those non-M1 funds coming into Super-Nows.

The Fed's second explanation of the over-target money growth has been that velocity—the relationship between money and GNP—may have changed. Because of uncertainty stemming from, among other things, concerns over future employment, individuals have temporarily increased their precautionary money balances. The Fed has thus been willing to tolerate "abnormal" growth in M1, under the assumption that the buildup in precautionary balances would be reversed, although the absence of any reversal so far now appears to have generated concern at the Fed.

Up to now, these two arguments have been used by the Fed to explain its shift in emphasis from M1 to the broader aggregates. Chairman Volcker indicated in his testimony before the Senate Banking Committee in February that M1 would become important only when it again became well-behaved. In reality, however, emphasis may have been changed not because the new aggregates made more economic sense, but because the Fed thought it had an increased likelihood of hitting its targets. This, in turn, provided a rationale for conducting a more expansionary monetary policy aimed at bolstering economic recovery.

Now, however—just as many analysts have become convinced that the Fed has completely abandoned its resolution to contain money growth—the surprising remarks by Chairman Volcker, on the heels of a spate of bullish economic news, may be a signal that a more-stringent policy is in the offing.

Robert S. Smith

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS					MONEY AND BANKING							COUNTRIES	
			6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes			exchange rate in U.S. dollars	change from year earlier	current monetary conditions		
													latest data	consumer prices	latest data					money supply(M1)
Africa	Algeria	Agreement reached with Italy on the volume and price of gas exports from the Transmed Pipeline.	Nov.	-14%	36.0*	1,935	Jan.	2,230	-38%	0.9	0	Oil output averaged 702,000 b/d in 1982, down 13% from the previous year.	Dec. '80	+10%	May	+23%	.2141	-6%	Foreign-exchange reserves fell \$1.3 billion last year.	Algeria
	Angola	Investment policy to concentrate on rehabilitation and rationalization.	n. a.	—	3.9	525	n. a.	—	—	—	—	Export financing agreements should sustain level of essential imports.	n. a.	—	—	—	.0330	-9%	Financial austerity continues.	Angola
	Egypt	Top priority given to new investment, restraint of non-essential import growth.	Sept.	-15%	30.8	710	Nov.	743	-7%	1.2	57	Oil price cut again in February by \$1.2 per barrel.	Nov.	+12%	Nov.	+24%	1.2100	0%	Money supply rising steadily.	Egypt
	Kenya	Economic growth—estimated at 3% in 1982—continues to slow; 2% growth projected for 1983.	May	-9%	6.6	383	Jan.	189	-20%	1.2	337	No significant near-term improvement seen for balance-of-payments position.	Aug.	+24%	Nov.	+10%	.0850	-10%	Banks' liquid-asset requirement raised to 20%.	Kenya
	Liberia	IMF disbursed \$33 million loan tranche March 3.	June	-17%	0.8	412	Nov.	14	+72%	0.4	160	Rubber and iron-ore exports continue to stagnate.	July	+16%	n. a.	—	Par	0%	Credit to private sector stagnates.	Liberia
	Libya	Budget for 1983 projects development outlays of \$8 billion, down 8.9% from 1982 allocation.	Nov.	+69%	30.3	9,800	Dec.	7,050	-22%	17.7	0	Oil production averaged 1.15 mbd last year, up nearly 4% from 1981.	n. a.	n. a.	June	+0%	3.3770	-1%	Foreign-exchange reserves fell by \$1.94 billion last year.	Libya
	Morocco	France agrees to 1982 financial aid package of FF 1.8 billion, up from FF 1.4 billion last year.	Oct.	-15%	15.2	735	Dec.	218	-5%	0.6	856	Tourists visiting Morocco last year numbered 1.95 mn., up 18.2% from 1981.	Nov.	+7%	June	+12%	.1570	-16%	State phosphate co. to borrow \$25 mn. in eurocurrency mkt.	Morocco
	Nigeria	Manufacturers hard hit by expulsion of foreign labor, growing shortages of imported raw materials.	Nov.	+21%	86.8	1,125	Dec.	1,613	-59%	0.9	0	Imports fall as foreign-exchange shortages cause payments delays.	Sept.	+4%	Sept.	+5%	1.4976	-2%	Reserves fall to one-month import cover.	Nigeria
	Senegal	New five-year plan to develop tourism, phosphates, and iron ore.	n. a.	—	2.3	400	Nov.	6	+12%	0.1	181	IDA backs oil exploration with \$9.6 million loan.	Oct.	+16%	Sept.	+19%	.002928	-12%	Currently tight credit conditions expected to improve.	Senegal
	South Africa	Farmers hit by drought and falling prices.	Dec.	-6%	77.5	2,573	Jan.	904	+54%	0.6	864	Fusion of financial and com'l rands ends capital controls over non-residents.	Dec.	+14%	Nov.	+21%	.9175	-7%	Prime rate cut by 2 percentage points to 14%.	South Africa
Middle East	Sudan	Standard Oil of California will construct 900-mile oil pipeline to Red Sea.	June	-47%	9.0	482	Jan.	18	+3%	0.2	489	February donors' meeting pledged \$750 mn.; \$440 mn. to be disbursed rapidly.	Feb.	+14%	Nov.	+31%	.7601	-32%	Liquidity problems continue.	Sudan
	Zambia	Economy expected to stagnate this year, after estimated 5% contraction in 1982.	June	+15%	3.5	587	Nov.	45	-81%	0.5	622	Despite deteriorating plant, copper output has risen above 600,000-ton level.	June	+13%	Nov.	+9%	1.0686	-3%	Kwacha devalued by 20% on January 7.	Zambia
	Zimbabwe	Restrictive policies, drought, and world recession expected to cause real GDP decline in 1983.	Aug.	-11%	6.7	870	Nov.	137	-5%	1.1	0	Sharp cutbacks in private-sector currency allocations to trim imports.	Oct.	+18%	Aug.	+12%	1.0550	-24%	Inflation at mid-year expected to reach 25%.	Zimbabwe
	Jordan	Official economic growth target for 1983 is 8%, compared with about 9% last year.	June	+13%	4.5	1,341	Dec.	884	-19%	3.3	0	Industrial exports totaled \$293 million in 1982 first half, 53% over year earlier.	Sept.	+7%	Nov.	+13%	2.8228	-2%	Bank claims on government rising steadily.	Jordan
	Kuwait	Additional measures being implemented to alleviate stock-market problems.	Nov.	+1%	24.3	17,350	Jan.	5,576**	+39%	8.6	0	Oil output averaged 828,000 b/d last year, down 26% from 1981.	April	+7%	Nov.	+8%	3.4273	-3%	Foreign-exchange reserves in 1982 rose by \$1.85 billion.	Kuwait
	Qatar	Foreign partners selected for \$5.6 billion LNG project to export gas from offshore North Field.	Nov.	-8%	6.0	24,000	March	392**	+12%	2.9	0	Oil output averaged 828,000 b/d last year, down 26% from 1981.	n. a.	n. a.	March	+50%	.2747	-8%	Claims on private sector rising steadily.	Qatar
	Saudi Arabia	SAMA officials suggest that accumulated foreign assets could be used to finance development outlays.	Nov.	-35%	155.8	16,719	Jan.	27,911**	-15%	2.4	0	Oil production averaged 6.45 mbd last year, down 34% from 1981.	March	-1%	Sept.	+19%	.2906	-1%	SAMA reiterates desire to limit rial use in syndications.	Saudi Arabia
	United Arab Emirates	Actual federal budget deficit was \$1.09 billion in 1982, 74% more than forecast.	Nov.	-20%	29.8	29,780	Oct.	3,111**	-1%	4.1	0	Abu Dhabi oil output averaged 849,000 b/d last year, 25% below 1981.	n. a.	n. a.	Nov.	+6%	.2730	0%	New stock exchange may open in September.	United Arab Emirates

*1980

**excluding state reserves

World Interest Rates

market rates of March 9, 1983; bond yields as of March 4, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.38	11.00 intervention rate	11.50	9.50	5.00	19.00 penalty rate 22.00	4.00	4.50	5.50
Day-to-Day Money	8.375 March 10	10.00	11.00	8.55	12.875	5.80	19.00	4.625	4.00 1-month Euro-Swiss fr. rate	6.875
Treasury Bills 91-day, Middle Rates	8.26	9.20	10.75	12.25	n. a.	n. a.	17.452 77 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.35 finance paper 15% tax w/h	9.502	11.40 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.55	9.30 15% tax w/h	10.813	11.40 Certified	not traded	6.00	19.30	no market	3.875	no market
Government Bonds Long-term, new and old issues, average yield	10.62	12.17	10.75	10.51	14.02	7.50	18.78	7.62	4.25	7.262
Industrial Bonds prime, long-term, new and old issues, average yield	11.40 As Industrials	12.40	12.61	12.41	15.14	7.60	18.65	8.02	5.79	6.44
Bank Short-Term Rate (prime rate)	10.50	11.25	11.00	15.50	14.55	9.00	20.00 1/4 qtrly fee on outstg.	6.50	7.50	6.00
Bank Time Deposits 3-month	8.50 Cert. of Dep.	9.25	11.125	12.15	13.375	5.25	11.50	4.625 large deposits	1.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.3125	9.75	11.25	no market	38.50	5.3125	no market	4.75	3.625	6.875
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8155	1.506	.0211	.1459	.4155	.0007	.3748	.4862	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.490 D	2.019 D	8.861 D	22.216 D	4.332 P	15.977 D	4.803 P	5.677 P	2.567 P
Eurodollar Deposits (London, interbank, bid) March 10	International Arbitrage (3-month, hedged) + in favor of U.S. dollars				Eurobonds (average yield on recent straight debt issues)			Gold Price		
7-day 8.8125	U.S.-U.K. Treasury Bills — 0.324				U.S. Dollar Bonds 11.00			London afternoon fixing		
1-month 9.00	U.S.-Canada Treasury Bills — 0.120				7 yrs. and under 11.25					
3-month 9.125	U.S.-Canada Finance Co. Paper — 0.232				DM Bonds 7.75			426.00		
6-month 9.8125	Eurodollars-U.K. Local Auth. Deposits + 0.394				7 yrs. and under 7.75			(per fine ounce)		

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Jan.) 3.8	(Jan.) 8.3	(Jan.) 4.9	(Jan.) 9.6	(Feb.) 3.8	(Feb.) 15.1	(Jan.) 4.8	(Feb.) 2.3
Industrial production*	(Jan.) -3.2	(Nov.) -11.6	(Dec.) 1.3	(Dec.) -3.0	(Jan.) -1.9	(Dec.) -5.9	(Sept.) -8.0	(Jan.) -1.3
Trade balance† (billions of local currency units)	(Jan.) -\$3.20	(Dec.) C\$1.80	(Jan.) -£0.49	(Jan.) -FF9.58	(Jan.) DM2.70	(Dec.) -Lit.1,130	(Jan.) -SF0.63	(Jan.) -¥144.8
Money supply (M1)*	(Jan.) 7.5	(Jan.) 7.8	(Dec.) 11.0	(Sept.) 10.8	(Dec.) 6.8	(Oct.) 15.1	(Nov.) 12.1	(Nov.) 5.0
Velocity of money (M1)*	(Dec.) -4.8	(Sept.) 1.1	(Sept.) -4.7	(June)** 2.2	(Sept.) -3.1	(Sept.)** 2.8	(March)** 9.3	(Sept.) 0.1
Reserves minus gold (\$ million, change from previous month)	(Jan.) -20	(Jan.) 330	(Jan.) -1,559	(Jan.) 2,945	(Jan.) 1,395	(Jan.) 1,149	(Jan.) -2,689	(Jan.) 329

* Percent change from 12 months earlier.

** based on GDP.

† Figures are only for the month indicated

Adjusting to Lower Oil Prices

The intrigue surrounding world oil prices goes on. OPEC is now in its third month of disarray over what to do about its weakening grip on the lion's share of the global oil market. The optimism of some members of the cartel that an accord on prices and production would be reached quickly has faded. And about the only thing that is certain is that prices are bound to come down. How far they will fall, at this point, is virtually anybody's guess.

A significant decline in oil prices would have measurable effects—both direct and indirect—on essentially every region of the world. But because these effects would pull in different directions and with uncertain magnitudes, the overall impact is difficult to estimate in precise quantitative terms. Nevertheless, tracing the effects of a hypothetical price drop on world economic growth, inflation, interest rates, and changes in international financial balances can provide useful insights for the future.

Perhaps even more important in evaluating the ultimate impact, however, is an awareness of the changes that are already under way—in global saving and capital investment, for example—in anticipation of the oil-price fall. For as fascinating as the OPEC-price drama might be, the world economy is not waiting to see how it is played out; the transition to lower oil prices has already begun. Furthermore, the reactions of policymakers to changes in the economy during this period of transition will be critical to the long-term economic outlook.

Global consequences

While the magnitude and the timing of the oil-price drop is still unknown, it is possible to gain useful information about its impact by choosing a specific lower price and estimating the effects it would have on the international economy. Chase has calculated the impact on different regions of the world of a 20% decline in the price of oil (a drop of around \$6 from the current "marker" price of \$34 per barrel for Saudi Arabian light crude). Abstracting from possible financial disruptions that could occur during an abrupt transition to a lower price path, the study indicates that such a decline would bolster the global economic recovery and result in significantly lower inflation and interest rates at least through the mid-1980s. These advances, in turn, would bring a marked improvement to international payments balances for many areas of the world.

For example, real growth in the 24 member countries of the OECD would accelerate, on aggregate, between one-half and three-quarters of a percentage point over the period 1983-85. In addition, annual increases in inflation, as measured by GDP deflators,

would be about one percentage point less than might have been expected without the oil-price decline. Partly because of the reduced inflation, short-term interest rates would also be likely to be about 100 basis points lower in late 1983 and in 1984.

The table below illustrates the effects of such an oil-price break on the OECD current account. In 1982, OECD net imports of fuels came to approximately \$225 billion. Based on this figure, the initial stimulus to these industrialized economies of a \$6-per-barrel price drop would be approximately \$45 billion. The combination of the lower price and the stepped-up economic activity would undoubtedly lead to an increase in the *volume* of OECD oil imports. However, because of the continuing effects of energy conservation and interfuel substitution, the boost in the demand for OPEC oil would probably be held to 1%-2%. Among the other effects the OECD economies could expect would be: a loss of revenues from exports to the OPEC countries as they adjusted to lower incomes; an increase in the volume of imports of raw materials and manufactured goods from the centrally planned economies (CPEs) and non-oil developing countries (NODCs); and lower net revenues from services and investment income. The industrialized countries could also expect a modest rise in exports to the NODCs, as lower oil prices freed up their scarce resources for other uses. For the OECD as a whole, the net effect of this hypothetical price decline in 1983 would be a \$13-billion improvement in the current account from what it might have been without the oil-price break.

For some of the other regions of the world, the current-account effects of a 20% price drop would be even greater, as the table on the next page shows. For OPEC, the offsets to the initial oil-revenue loss are smaller than those for the OECD. This is because net investment income is also curbed by lower interest rates and reduced OPEC assets as oil producers finance their current-account deficits by spending out of reserves and by borrowing in the capital markets.

For the centrally planned economies, the major

Annualized impact of an oil-price break on the OECD current account

	\$ billions
Initial oil-price effect on fuel imports (20% drop in \$225 billion flow)	+ 45
Higher volume of oil imports (consumption plus restocking)	- 8
Lower revenues from exports to OPEC (10% drop in \$120 billion flow)	- 12
Higher volume of imports from NODCs and CPEs (5% increase in \$200 billion flow)	- 10
Lower revenues from services and investment income	- 5
Higher exports to NODCs	+ 3
Net effect on OECD current account:	+ 13

Adjusting to Lower Oil Prices *(continued from page 7)*

losses stemming from the fall in oil prices would be absorbed by the energy exporters—the Soviet Union and China. Such losses should not entail any major program adjustments, however, since in these countries, reserves are high and debts are low. The gains from expanded OECD imports and lower interest costs, on the other hand, would accrue mainly to Eastern Europe.

For the non-oil developing countries, the initial impact on economic growth is relatively modest. Although higher OECD demand for exports provides some boost, the effect in 1983 would probably be limited to a rise in GDP of no more than one-quarter of a percentage point on average. However, the current accounts of the NODCs would also benefit from reduced interest payments. And in 1984, the combination of higher OECD growth and lower oil prices could stimulate a strong recovery for at least some of these developing countries. By 1985, overall real growth in the NODCs could recover to around 4.5%.

Saving and investment

A swing in the regional current accounts of the magnitude suggested by the table is much smaller than the shift experienced during the last oil shock of 1979-80 and smaller than the annual swings in 1981-82. Still, some analysts have expressed concern over the shift of current income from regions with a high rate of saving (the Arab Gulf) to regions with low savings rates (the United States and Europe). Some have even suggested that there could be a fall in global savings that would place upward pressure on interest rates—both nominal and real. Such analyses, however, implicitly assume no adjustment in global real production and ignore the actual experience of 1979-81. The stimulative effects of a lower path for oil prices would generate sufficient savings in the global economy. Furthermore, a greater proportion of that saving would be done by oil-consuming individuals, corporations, and governments whose portfolios would contain a higher share of real productive assets.

Sustained economic growth beyond 1984-85 depends in part on the net effect of lower oil prices on capital investment. Expectations of an oil-price drop are already generating economic changes that will inevitably affect capital spending—both positively and negatively. On the negative side, increased price uncertainty, a reversal in the criteria for judging plant obsolescence, and changes in the average scale of capital projects may act to reduce global capital investment for at least a transitional period.

Offsetting these primarily negative influences, however, are several influences favorable to increased capital spending. Most important, expectations of a more rapid recovery in the OECD and the prospect of sustained real growth through the mid-1980s should

eventually boost capital expenditures significantly. Depending on what ultimately happens to interest rates and global saving, after a transitional period of perhaps six months to a year—in which capital investment may actually be less than if oil prices had held steady—a strong investment surge can be expected for 1984-85.

The shift in financial balances associated with an oil-price break should not by itself seriously affect international financial flows and world liquidity. However, a rapid transition with funding dislocations felt by various large commercial banks, together with uncertainty about the eventual magnitude of the shift in relative prices, could prompt individual commercial banks to contract their lending. Throughout the international capital markets, there would be intensified scrutiny of banks' asset quality and funding positions from correspondent banks, national regulators, and bank shareholders.

In that situation, mismanagement by central banks that allowed a contraction in world liquidity could be quite damaging to the international financial system. It is encouraging, though, that when the world's central bankers were presented with a similar test during the fall of 1982, they made correct decisions to sustain liquidity and confidence.

Consequences of an oil-price break on regional current accounts in 1983

	(\$ billions)				
	OECD	OPEC	NODC	CPE	TOTAL*
Current account: Initial projection	-30	-15	-53	-2	-100
Initial oil-price impact	45	-45	4	-4	
Oil volume effect	-8	8	0	0	
Non-oil net exports	-19	15	3.5	0.5	
Services and investment income	-5	-3	7.5	0.5	
Current account: New projection	-17	-40	-38	-5	-100

* The world current-account discrepancy was in the range of \$90 to \$100 billion in 1982. The areas where the largest discrepancies arise are in non-factor services, investment income, and official transfers. The offset to these balances aggregated over country data accrues largely to private individuals and businesses.

After a transition to lower oil prices in the mid-1980s, it would be appropriate for world monetary growth to slow down. At that time, the money demand increases associated with higher real growth would be offset by the lower growth in global price levels. Since 1980, the operation of OPEC—and Saudi Arabian production policy in particular—has kept world oil prices in terms of current dollars quite high, while other prices of non-fuel commodities and manufactured goods have actually fallen. This price rigidity in the oil market tended to concentrate the deflationary impact of slow money growth on other markets during the global recession. A break in oil prices in 1983 that persists through mid-decade, would, in turn, concentrate the stimulative effects of recent rapid world money growth on those other markets.

Donald W. Green

B1900-1 3/30/83

The U.S. Recovery: In Like a Lamb

Recently released data on the U.S. economy show that, although signs of recovery are clearly present, it is still too early to proclaim a boom. The persistence of rapid money growth since last summer had prompted a number of economists to forecast a first-quarter surge in real economic growth of 6% or more at an annualized rate—similar to the average rate of expansion in the early months of most previous recoveries. Preliminary data, however, from the Commerce Department's so-called "flash estimate" of January-March economic performance, project real growth of only 4%.

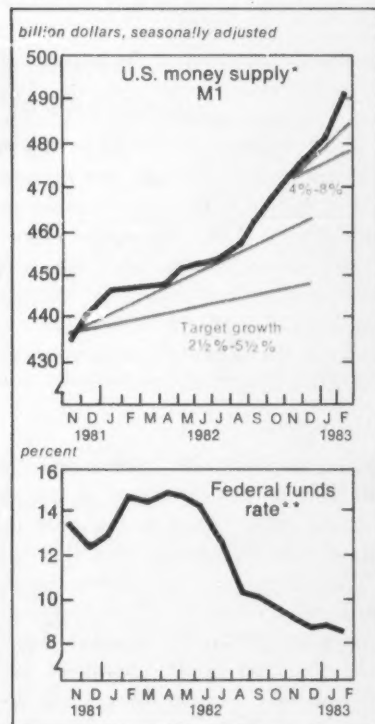
Other statistics suggest that even this less-than-robust growth is largely the result of a reduced rate of inventory liquidation. Retail sales declined in February for the third consecutive month, and business investment and exports remain on a downtrend. The only "boom" in the economy appears to be taking place in residential construction. The number of housing units started in January and February almost doubled the trough level reached early in 1982. (See page 4.)

One reason the pace of the current recovery may be slower than average is that interest rates seem stubbornly stuck on a relatively high plateau. Rising unemployment and a striking slowdown in inflation enabled the Federal Reserve to adopt a more accommodative stance in early October. And without the threat of the Fed tightening, interest rates fell sharply from their summer peaks, spurring the dramatic rebound in housing. Since then, however, three additional cuts in the discount rate have had little effect on the overall level of market interest rates except to steepen the yield curve beyond one year. This steepening reflects market expectations that: (1) the Fed will eventually respond to continuing above-target money growth by slowing the growth of reserves, or (2) inflation expectations will rise. Either would lead to higher interest rates.

In various speeches lately, Fed Chairman Volcker has hinted that the monetary authorities will be less tolerant of high money growth. This has once again raised fears of a Fed tightening. Interest rates have, in fact, moved up slightly in the past two weeks. Given the current state of the economy, any further rise in rates could damage the confidence of both consumers and businesses, and hence, threaten the incipient recovery.

A more restrictive stance by the Fed might well prove unnecessary if money growth slows in March and April, as seems likely with only a moderate rise in economic activity and continued low inflation. The markets would then be able to take rates lower without any aggressive easing by the Fed—moves that would inevitably risk rekindling inflation expectations.

U.S. money growth and short-term interest rates



*monthly average of weekly figures
**monthly average of daily figures

Realignment in the European Monetary System.

Declines in textiles and tourism lead to unemployment rise for Malta.

Turkish government forecasts further current-account improvement.

Outlook for Chilean economy remains bleak.

After protracted and sometimes acrimonious negotiations—following weeks of speculative pressure—the EMS currencies were realigned on March 21. The German mark was revalued by 5.5%, while the French franc was devalued by 2.5%. Other changes included revaluations of 3.5% for the Dutch guilder, 1.5% for the Belgian franc, and 2.5% for the Danish krone—keeping its trade-weighted exchange rate almost constant. On the downside, the Italian lira was devalued by 2.5%. And the Irish pound—whose parity had been left unchanged since the formation of the EMS in 1979—despite Ireland's high rate of inflation, was devalued by 3.5%. Although France has asserted that the franc's devaluation was relatively small, from a world viewpoint, the change was clearly significant. And while the revaluation of the mark was essentially a revaluation in name only, this latest realignment has effectively depressed the whole EMS snake.

Malta has been inevitably hard hit by the current world recession. The textile sector, in particular, has faced declining product demand and increased competition from lower-cost producers. The value of textile and clothing production in the first three quarters of 1982 declined by 15% from that of the same period of 1980, contributing to a 20% drop in employment. Tourism has fallen off dramatically as well, with arrivals in 1982 down to only 50,000, more than 30% lower than the 1980 peak. On the whole, the economy has managed to sustain some growth—perhaps 2% for all of 1982—as a result of rising output in other specific manufacturing industries, expanded ship repair activity, and strong construction performance stemming largely from work on new port and dock facilities. Nevertheless, unemployment has been rising rapidly. Latest available figures show that joblessness climbed to 7.1% of the labor force last September, up from only 5% a year earlier. The government has responded by accelerating spending on additional new port facilities and other labor-intensive projects and by launching a pay and price freeze.

Official statistics suggest that Turkey made continued gains in its balance-of-payments position last year. Spurred by an undervalued exchange rate, 1982 exports grew by some 20% in dollar terms while imports remained flat. As a result, despite lower net invisible earnings brought on by higher interest payments on external debt and lower remittances from Turkish workers abroad, the current-account deficit halved in 1982 to an estimated \$1 billion. This improvement occurred despite real GNP growth officially estimated at 4.4%, admittedly accompanied by a downturn in stockbuilding. For 1983, the authorities are forecasting a slight acceleration in real growth to 4.8% and another halving of the current-account deficit. In the longer term, however, Turkish authorities will have to guard against boosting domestic demand because of the attendant risks of catch-up import growth—if the high debt-service burden projected for 1984-85 is to be financed.

The Chilean economy suffered a severe 14% decline last year. A downturn in 1982 had been widely viewed as inevitable in light of the slowdown in foreign lending and continued world recession. However, the deterioration was much worse than had been anticipated because of an untimely devaluation in June that was followed by inconsistent economic policies. This stimulated speculative capital outflow and at the same time discouraged external borrowing. Chile lost some \$1 billion in liquid reserves from June to December—twice the amount lost in the first half of 1982. The stepped-up demand for local funds, combined with the large reserve loss, resulted in even higher domestic interest rates. Chile lost an additional \$400 million in the first two months of this year—an amount that would have been even higher if the IMF had not disbursed to the country about \$490 million. In the absence of a substantial pickup in the industrial economies, the prospects for Chile in 1983 are not bright: Recovery will continue to be constrained by an untenable foreign-exchange position, accompanied by a crisis of confidence on the part of both local and foreign investors.

Panamanian economic growth expected to slow but remain positive.

Prospects for continued budget deficits may force Hong Kong government to change policies.

Economic outlook for the Philippines shows promise.

Iranian budget plans large increase in development spending.

Despite international recession and the decline of world trade in 1982, the Panamanian economy managed to achieve real GDP growth of about 3%. The forces behind the advance included greater activity and higher income from the Canal, rising construction expenditures for office buildings and the Petroterminals oil pipeline project, increased banana exports, and continued growth of the banking and insurance sectors. Activity was down, however, in the Colon Free Zone owing to the general Latin American slowdown, and wholesale trade and tourism fell below year-ago levels. The outlook for 1983 suggests an economy not as strong as in 1982. In a steady effort to contain the public-sector deficit, government expenditures are being held down and greater efforts are being made to generate fiscal income. Moreover, some of the larger construction projects have now been completed, and Free Zone activity remains depressed. As a result, the economy in 1983 is likely to record growth lower than the 1982 advance but still avoid an absolute decline.

The Hong Kong government is expected to post a budget deficit of HK\$3.9 billion in the fiscal year ending March 31—the first deficit in nearly a decade. The government in recent years has relied heavily on lucrative land sales to finance rapid public-sector spending increases. But the collapse of the real-estate market has resulted in an estimated HK\$7.9-billion revenue shortfall. Faced with continued depressed property-sale earnings and an even larger budget deficit in the coming year, Financial Secretary Bremridge recently announced new indirect tax measures designed to raise some HK\$3 billion. Overall spending is slated to show only a small increase in real terms. Still, a deficit of HK\$3.2 billion remains to be financed out of reserves. So far, the financial secretary has ruled out borrowing to cover the shortfalls. But a continuation of these deficits even after the economy rebounds is highly possible and could force the government to change its fiscal policies—to increase corporate taxes, cut expenditures, or borrow—in order to cope.

The economy of the Philippines deteriorated noticeably in 1982: GDP growth slowed to 2.5% from 3.8% in 1981, and the current-account deficit swelled to nearly \$3.4 billion—some 8.5% of GNP—from \$2.3 billion in the previous year, largely owing to a 12.7% drop in exports. Long-term external debt climbed to almost \$13 billion, bringing the debt-service ratio (World Bank definition) to 27%. This year, however, is already promising improvement. There have been significant increases in the prices of copper and coconut oil from last year's lows, and reduced oil prices will also be helpful. In addition, lower Eurodollar rates will save the Philippines several hundred million dollars in interest costs this year, while the signing of new agreements with the IMF and World Bank assures additional credits totaling \$850 million. Finally, a new round of negotiations with the United States over military base rights is scheduled for this spring, and the Philippines will probably win substantial aid commitments.

Despite a weakened world oil market and continued war with Iraq, the Iranian government's 1983/84 budget aims to give a new fillip to the domestic economy. The authorities have clearly demonstrated their desire to rebuild domestic productive capacity by boosting the allocation for development spending some 30%—to 1,200 billion rials from 922 billion rials in the previous fiscal year—with top priority apparently going to agriculture and heavy industry. At the same time, growth of current expenditures (excluding allocations for the Gulf War) has been held to 1% in an attempt to rein in inflation, which was running at an official year-on-year rate of 17% as of the third quarter of 1982. Government revenue forecasts in the new budget, however, are likely to be proved overly optimistic, inasmuch as they were based on oil-export projections averaging 2 million b/d at \$30 per barrel. Given the latest OPEC agreement to cut prices and Iran's reported willingness to accept an overall output quota of 2.4 million b/d—and thus export volumes of only 1.9 million b/d—there is a likelihood that budget revenues will undershoot officially forecast levels even if oil market conditions stabilize.

A Solid Recovery for Housing

Thanks to the drop in interest rates from their summer peaks, residential real-estate activity is far and away the leading force in the U.S. economic recovery. In January and February, builders started construction of new housing units at a rate very nearly double that of the same months of 1982. Sales of existing houses have also improved substantially. And the beneficial results of this rising activity are being felt in other sectors of the economy as well.

A year ago, mortgage interest rates ranged upwards of 17%—a rate that is well outside what the financial status of the vast majority of Americans will bear. Moreover, mortgage money was scarce because of deposit outflows from the savings institutions that write the bulk of home mortgages. Interest rates began to come down—and savings deposit flows to improve—in the second half of 1982, however. Residential mortgage rates have recently been in the neighborhood of 13%.

New housing starts, which had fallen to an annual rate of less than 1 million in the first nine months of 1982, rose to 1.25 million for the last three months of the year, and passed 1.7 million this January and February. (For perspective, the average figure for the last five years of the 1970s was approximately 1.7 million units per year.) Sales of new houses have risen smartly and the inventory of unsold new homes fell to a 5½-month supply in January—as low as it has been in six years.

Sales for existing homes are also up, by some 40% from their low point last summer. Families who move into existing houses frequently find themselves buying new furniture and household appliances in the process, and retail sales of appliances have indeed begun to improve after a long period of decline. Also as a result of the rise in housing starts, activity in the building-materials industries—which had been among the most depressed in the nation—has begun to stir.

It is unlikely that the recent pace of improvement can be sustained for long. For one thing, mortgage rates have recently backed up along with other rates. The increase has not been—and is not expected to be—great enough to put housing back in the doldrums at any time this year. But it may be enough to dampen some of the recent buying enthusiasm. In addition, it appears that the January-February figures on housing starts had the benefit of some special factors. The weather in January was not its usual beastly self this year, which made construction possible in some parts of the country where it is usually less active in the winter. And there was a sudden and probably temporary burst of multi-family starts in February. Even thus qualified, however, the recovery in residential real-estate activity—and its many suppliers—is a real one. Experts now generally forecast starts of as many as 1½ million units this year, for a gain of some 40% over the miserable 1982 total.

Richard W. Everett

Budget Woes Haunt the Muni Market

The municipal-bond market is gearing up to handle another year of heavy volume of tax-exempt offerings this year, as state and local governments continue to undergo significant fiscal strain. Fortunately, the market seems willing and able to assume the task. But a large volume of refundings and new issues—amid mounting concerns over credit quality and liquidity—could keep strong upward pressure on yields of muni notes and bonds.

Depressed revenues and higher spending demands last year forced state and local governments to boost their borrowing by 43% over 1981 levels, to a record \$122 billion. For long-term general-obligation issues alone, the increase was 65%. To be sure, much of the revenue shortfall stems from the recession. But, while the recovery will provide some relief from these cyclical pressures, it will not alleviate the burdens caused by other forces of a longer duration.

The first of these is the changing structure of the economy. The industrial sector seems to be contracting to a more-compact—if more-efficient—size, leading in some areas to permanently closed plants and reduced employment. For many state and local governments, this decline of heavy industry will erode the tax base while spurring expenditures on the unemployed. Over time, new industries will emerge and redundant workers will develop new skills. But in the interim, state and local governments will have to do more with less.

Another force affecting the budget planning—and borrowing ability—of these governments is the effort by the Reagan administration to create a "New Federalism," transferring many federal functions to the states and municipalities. While this attempt is temporarily on the back burner, it is not a dead issue and the markets are somewhat wary.

A third strain on state and local government finances results from high rates of interest, still close to historical peaks. During 1982, rates on new 10-year AA general-obligation bonds averaged 9.69%—far above the average rates of 6.85% in 1980 and 5.63% in 1975. As state and local governments accumulate new debt or roll-over old issues, more of their limited resources will go to debt servicing, a trend they can ill-afford.

Thanks to a number of market innovations—which have greatly increased the attractiveness of tax-free municipal securities to investors—the market appears willing and able to absorb the heavy flow of debt issues that will result from these forces. These innovations include the greater availability of mutual funds, unit trusts, and insured securities, which have served, respectively, to increase liquidity, to allow for diversification with a set maturity and yield, and to reduce credit risk for investors. The combination is likely to prove attractive enough to lure funds sufficient to meet prospective borrower needs. But the price will be municipal yields that remain historically high relative to rates on taxable debt.

Vincent Salvo

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in \$ million	12-month change	months of imports covered	use of IMF credit, mil- lions of dollars	current influences on payments	12-month changes		central bank rate ^Δ in U.S. dollars	exchange rate March 23, 1983	current monetary conditions			
												latest data	consumer prices				latest data		money supply(M1)
Austria	Economic conditions set to improve with recovery in rest of Europe.	Oct.	-4%	65.8	0	Jan.	4,921	- 2%	3.1	0	Current account now in surplus—exchange rate remains undervalued.	Feb.	+ 4%	Dec.	+ 8%	3.75%	.0595	Interest rates reduced in line with German cuts.	Austria
Belgium	Government seeks further spending cuts to reduce public-sector deficit.	Oct.	0	97.1	-2.0%	Jan.	4,279	- 3%	1.0	0	Trade deficit narrowed sharply in second half of 1982.	Jan.	+ 8%	Sept.	+ 7%	11.00%	.0209	Interest pressure eases after EMS adjustment.	Belgium
Britain	March 15 budget injects £2 billion and prompts official forecast of 2% growth in 1983.	Jan.	+2%	505.8	-2.0%	Jan.	10,838	-27%	1.3	0	Market surprised by Jan. current-account deficit; return to deficit still expected.	Feb.	+ 5%	Dec.	+11%	10.56%	1.4645	Bank base rates cut; new money growth targets announced.	Britain
Denmark	Little improvement expected this year from 1982's 1.5% growth.	Nov.	+6%	55.9	-0.2%	Jan.	2,925	+27%	2.2	0	Jan. saw first trade surplus in 16 months owing to lower imported oil costs.	Feb.	+ 9%	Sept.	+11%	8.50%	.1162	Discount-rate cut after EMS adjustments.	Denmark
Finland	Growth expected to pick up in 1983, following 1982's poor performance.	Nov.	0	48.3	+1.4%	Jan.	1,511	+19%	1.3	16	Analysts hope for a small current-account surplus this year after 1982's deficit.	Jan.	+ 8%	Oct.	+20%	8.50%	.1838	Money markets remain closely regulated.	Finland
France	No upturn seen for near future; further austerity measures likely.	Jan.	-1%	568.5	+0.3%	Jan.	19,476	- 5%	2.1	0	Trade deficit sharply wider in Jan.; 1983 goal to narrow gap to FF 45 billion.	Jan.	+10%	Oct.	+15%	9.50%	.1380	Franc devalued in EMS.	France
Germany	Leading indicators turn up during November-January period; recovery likely in latter 1983.	Dec.	-4%	685.5	-0.2%	Jan.	46,157	+11%	3.7	0	Current-account surplus to rise owing to falling oil prices.	Jan.	+ 4%	Dec.	+ 7%	4.00%	.4124	Key interest rates cut by one percentage point.	Germany
Ireland	Tough budget announced in Feb. will prevent any significant growth in output this year.	Aug.	-3%	16.2	+1.1%	Nov.	2,309	-15%	2.9	0	Current-account forecast revised to show 1983 deficit of 500 million Irish pounds.	Jan.	+12%	Oct.	+10%	14.00%	1.3000	First devaluation since formation of EMS.	Ireland
Italy	Economic indicators remain lacklustre; real GNP likely to remain flat in 1983.	Jan.	-5%	350.6	-0.2%	Jan.	15,258	-21%	2.3	0	Trade deficit widens in January, but set to decline soon.	Jan.	+16%	Sept.	+15%	19.00%	.000694	Large public-sector deficit keeping interest rates high.	Italy
Netherlands	Prospects raised for further fiscal tightening; real consumption spending likely to decline this year.	Nov.	-6%	137.9**	-0.8%**	Jan.	11,002	+24%	2.1	0	Current-account surplus looks set to widen further in 1983.	Jan.	+ 4%	Nov.	+ 6%	3.50%	.3774	Guilder remains strong member of EMS; interest rates cut.	Netherlands
Norway	Lower oil prices may force some policy changes, but economy expected to be flat.	Nov.	-2%	55.6	+0.8%	Jan.	6,620	+10%	5.3	0	Reduced oil revenues likely to push Norway into deficit this year.	Feb.	+10%	Oct.	+ 8%	9.00%	.1386	Interest rates, exchange rates remain steady.	Norway
Portugal	April 25 election continues to create uncertainty.	Aug.	+9%	23.5*	+5.5%*	Dec.	449	-17%	0.6	3	Current-account deficit for 1982 estimated at \$3.2 billion.	Nov.	+19%	Aug.	+12%	23.00%	.0100	Last October M2 growth was 30.3%, year on year.	Portugal
Spain	GDP growth in 1982 was 1.3%.	Oct.	-1%	183.7	+0.3%	Dec.	7,655	-29%	3.2	5	Current-account deficit expected to fall below \$3 billion.	Jan.	+14%	Nov.	+13%	8.00%	.0074	M3 target for 1983 set at 13%.	Spain
Sweden	Government hopes for export-led growth in wake of last October's devaluation.	Nov.	-1%	111.5	-0.7%	Jan.	3,390	0	1.5	0	January saw kr 100 million trade deficit, vs. 930 million year earlier.	Jan.	+10%	Dec.	+10%	9.00%	.1331	Interest rates cut by 1% end-January.	Sweden
Switzerland	No growth is expected in 1983.	Sept.	-6%	99.4	+2.0%	Jan.	12,751	+16%	5.5	0	Current-account surplus expected to widen from last year's \$3.4 bn. figure.	Jan.	+ 5%	Nov.	+38%	4.00%	.4854	Franc slipped against DM in anticipation of EMS realignment.	Switzerland
Turkey	Real growth—officially estimated to have been 4.4% in 1982—expected to continue this year.	n. a.	n. a.	60.0	+4.4%	Dec.	923	-28%	1.3	1,515	Current-account deficit for 1982 halved to almost \$1 billion.	Dec.	+33%	Dec.	+23%	31.50%	.0051	Money growth accelerating.	Turkey
Canada	Sluggish economic activity persists; strong pick-up awaits recovery in the U.S.	Nov.	-6%	283.6**	-4.8%**	Jan.	3,341	- 4%	0.7	0	Greater fall in imports relative to exports yielded current-account surplus in '82.	Feb.	+ 7%	Dec.	+ 4%	9.47%	.8155	Fears of renewed inflation keep policies conservative.	Canada
United States	Housing boosts economy sharply, although other sectors remain weak.	Jan.	-3%	3,057.5**	-1.8%**	Jan.	22,791	+20%	1.1	0	Current account slid into \$8.1 billion deficit in 1983, further deterioration likely.	Jan.	+ 4%	Feb.	+10%	8.50%	—	Rapid money growth continues, credit markets nervous.	United States

*1980

**1982

^Δmost recently reported

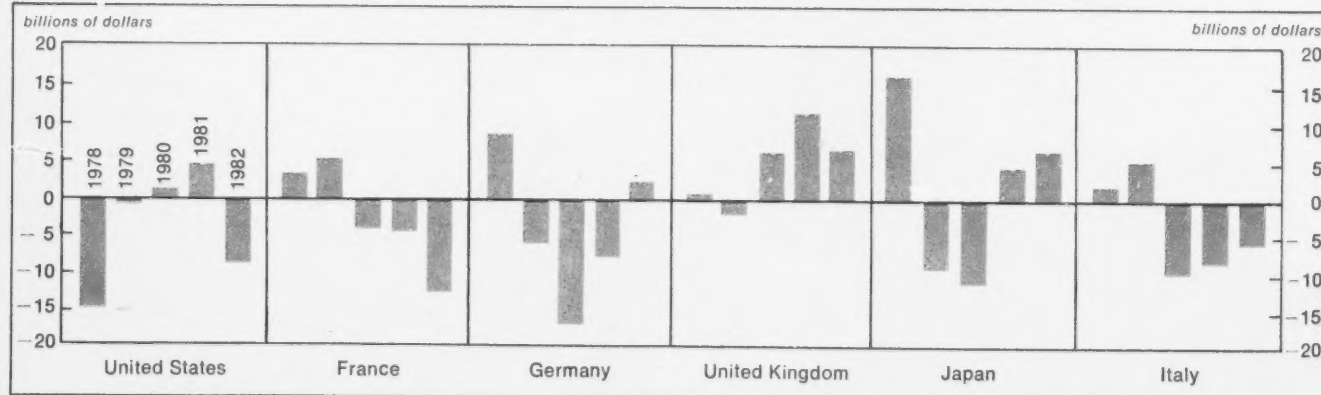
World Interest Rates

market rates as of March 23, 1983; bond yields as of March 18, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan																																																																													
Central Bank Discount Rate	8.50	9.47	10.563 intervention rate	11.00	9.50	4.00	19.00 penalty rate 22.00	3.50	4.00	5.50																																																																													
Day-to-Day Money	8.75 March 24	9.25	10.75	7.35	12.875	5.05	19.25	4.25	3.00 1-month Euro-Swiss fr. rate	6.625																																																																													
Treasury Bills 91-day, Middle Rates	8.45	9.15	10.219	12.25	n. s.	n. s.	17.352 63 days	no dealing	no market	5.625																																																																													
Commercial Paper prime, 3-month, asked	8.875 finance paper discount basis	9.30 finance paper 15% tax w/h	10.062	13.90 Certified	12.625 Interbank	no market	no market	no market	no market	not traded																																																																													
Bankers' Acceptances 3-month, asked	8.75	9.25 15% tax w/h	10.281	13.90 Certified	not traded	5.00	19.30	no market	4.00	no market																																																																													
Government Bonds Long-term, new and old issues, average yield	10.90	12.05	10.67	10.61	13.91	7.40	18.84	7.78	4.43	7.461*																																																																													
Industrial Bonds prime, long-term, new and old issues, average yield	11.65 As Industrials	12.80	12.35	12.29	15.00	7.50	18.25	8.13	5.89	6.45*																																																																													
Bank Short-Term Rate (prime rate)	10.50	11.50	10.50	18.00	14.55	8.00	20.00 1/8 qtrly fee on outstg.	6.00	7.50	6.00																																																																													
Bank Time Deposits 3-month	8.80 Cert. of Dep.	9.25	10.813	12.50	12.688	5.10	11.50 large deposits	4.50 residents only	2.75	3.75 20% tax w/h																																																																													
Eurocurrencies 3-month, asked	9.75	9.688	10.875	no market	14.25	5.00	no market	4.125	4.00	6.75																																																																													
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8157	1.4625	.0209	.1377	.4126	.0007	.3679	.4815	.0042																																																																													
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.049 P	0.985 D	3.484 D	4.648 D	4.944 P	10.405 D	5.545 P	5.815 P	2.959 P																																																																													
<table border="0"> <tr> <td colspan="2">Eurodollar Deposits (London, interbank, bid) March 24</td><td colspan="3">International Arbitrage (3-month, hedged) + in favor of U.S. dollars</td><td colspan="3">Eurobonds (average yield on recent straight debt issues)</td><td colspan="3">Gold Price</td></tr> <tr> <td>7-day</td><td>9.688</td><td>U.S.-U.K. Treasury Bills</td><td></td><td>-0.644</td><td>U.S. Dollar Bonds</td><td></td><td></td><td>London</td><td></td><td></td></tr> <tr> <td>1-month</td><td>9.438</td><td>U.S.-Canada Treasury Bills</td><td></td><td>-0.422</td><td>7 yrs. and under</td><td></td><td>11.00</td><td>afternoon fixing</td><td></td><td></td></tr> <tr> <td>3-month</td><td>9.500</td><td>U.S.-Canada Finance Co. Paper</td><td></td><td>-0.347</td><td>Over 7 yrs.</td><td></td><td>11.00</td><td></td><td></td><td></td></tr> <tr> <td>6-month</td><td>9.625</td><td>Eurodollars-U.K. Local Auth. Deposits</td><td></td><td>-0.015</td><td>DM Bonds</td><td></td><td>7.50</td><td>410.00</td><td></td><td></td></tr> <tr> <td></td><td></td><td></td><td></td><td></td><td>7 yrs. and under</td><td></td><td>7.75</td><td>(per fine ounce)</td><td></td><td></td></tr> <tr> <td></td><td></td><td></td><td></td><td></td><td>Over 7 yrs.</td><td></td><td></td><td></td><td></td><td></td></tr> </table>											Eurodollar Deposits (London, interbank, bid) March 24		International Arbitrage (3-month, hedged) + in favor of U.S. dollars			Eurobonds (average yield on recent straight debt issues)			Gold Price			7-day	9.688	U.S.-U.K. Treasury Bills		-0.644	U.S. Dollar Bonds			London			1-month	9.438	U.S.-Canada Treasury Bills		-0.422	7 yrs. and under		11.00	afternoon fixing			3-month	9.500	U.S.-Canada Finance Co. Paper		-0.347	Over 7 yrs.		11.00				6-month	9.625	Eurodollars-U.K. Local Auth. Deposits		-0.015	DM Bonds		7.50	410.00								7 yrs. and under		7.75	(per fine ounce)								Over 7 yrs.					
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
*Bond yields as of March 11.

Current-account balances of major industrial countries



Capital Investment Boom: Not Now but Later

For sustained global recovery, there must be a major revival of capital investment. As the last issue of *International Finance* (March 14) pointed out, falling world oil prices are already having both positive and negative effects on capital spending. While it is difficult to predict what the overall impact of the oil-price drop will be, it is possible to identify the major elements of change.

On the negative side, increased price uncertainty, a possible reversal of plant obsolescence, and a decline in the average project scale all may tend to reduce the overall level of capital investment—at least during a transitional period.

- For the first time in over a decade, there exists a serious downside risk for relative energy prices, in spite of the compromise on oil prices and production reached by the members of OPEC earlier this month. This raises the level of uncertainty over future returns on investments in energy production and conservation. One of the reasons global investment spending held up well into the past recession was that the expected rate of return from energy investments and energy conservation exceeded the rising real rate of interest. As the table below shows, U.S. and Japanese private non-residential investment grew moderately in 1981. In fact, the drop did not occur until the second half of 1982. Now, many energy-related projects will realize lower returns than expected since, overinvestment in such activities undercut the expected path for real energy prices.

- The decline in energy prices will also influence the criteria for scrapping existing capital by making some processing and manufacturing capacity once more profitable to operate. This will tend to reduce any derived demand for new construction, as capacity utilization rates increase during the recovery.

- Finally, the decline of revenues earned by energy

companies and oil-exporting nations will affect those recently prominent in contracting large-scale projects around the world. Many of these projects will now be either canceled entirely, stretched out, or scaled down. Moreover, the revenue gains of other industries and countries will not immediately evoke equivalent contracting for large projects. Instead, smaller contracts for replacement equipment, general-purpose machinery, transport equipment, and modernizing construction are likely to appear. Thus, there may be a transitional drop in total demand for fixed capital and a shift away from plant construction toward machinery.

To offset these negative influences, lower oil prices are also likely to have a number of positive effects on capital spending, as a result of—among other things—the complementarity of capital and energy in production, declining nominal interest rates, and the so-called “investment accelerator.”

- The evidence of the past decade, when energy prices were rising, suggests that capital and energy are complementary inputs in production, while capital/energy combinations are substitutes for labor. Consequently, lower relative energy prices should encourage a shift away from labor-intensive production techniques back toward capital/energy-intensive methods, stimulating purchases of capital equipment.

- At the same time, reduced oil prices will inevitably help to calm inflation expectations and eventually bring down nominal interest rates. Because this might not be sufficient to reduce real rates of interest, investment in machinery and plant may be unaffected. However, falling nominal rates have already raised the real wealth of households and stimulated residential investment. And this should help to offset the stagnation or decline in non-residential fixed investment expected in the largest OECD economies this year.

- Finally, the impact of what economists refer to as the “classical accelerator model”—which relates investment to underlying growth in output—should dominate all other capital-investment effects by 1984. Expectations of a more-rapid recovery in the OECD and the prospect of sustained real growth through the mid-1980s will increase the optimal level of capital stock for most enterprises. As firms adjust toward this higher target, capital spending will eventually rise faster than the expected growth of aggregate demand.

Thus, the outlook for capital spending suggests that after a transitional period of perhaps six months to a year, when investment may actually be less than if oil prices had held steady, a strong surge in orders and expenditures for capital goods can be expected for 1984-85. Of course, the principal risk to such an investment rebound would be the failure of real interest rates to decline from present levels.

Donald W. Green

Outlook for capital investment
(percentage change from previous year)

	1981	1982	1983	1984
United States				
Private fixed investment	1.7	- 6	2	8½
Private residential	-4.9	-10	25	10
Private non-residential	3.5	- 5	- 2	7½
Japan				
Fixed investment	2.1	- ¾	1¾	3
Public	4.7	0	- ½	- 2
Private residential	-1.1	- ¾	5	5
Private non-residential	1.7	- 1	2	5
Germany				
Fixed investment	-3.8	- 6½	1½	2½
Public	-7.7	-10	0	2½
Private residential	-4.0	- 7½	3	2
Private non-residential	-2.7	- 5	1½	2½

Data: OECD; Chase forecasts for 1983, 1984

U.S. Firms 'Discover' the Eurobond Market

For U.S. corporations, 1982 clearly represented the year the international bond markets came of age. Gross proceeds from Eurobonds and foreign bonds issued by U.S. companies last year totalled nearly \$15 billion—more than double the just-under \$7 billion in 1981.

Last year's activity also illustrated that market conditions in international and U.S. domestic bond markets often differ, providing corporate treasurers two different new-issue "windows" to tap for long-term funds. For example, in 1982, the volume of new corporate bond issues in the American market was depressed until August, while in the Eurobond market, the volume of new issues by U.S. corporations reached record highs in the first five months of the year.

Such differences can be explained, at least in part, by three forces. First, the Eurobond market last year proved much more "innovative" than its domestic dollar counterpart through the use of such features as zero-coupons, bond warrants, and partly-paid issues. These innovations often attracted new investors and provided issuers with a relatively cheap source of funds.

Another reason for the divergence of activity in the Euro- and U.S.-bond markets was that until early last year, American corporations had to go through time-consuming registration procedures to issue bonds in the domestic market, while an issuer could tap the Eurobond market with virtually no lead time. And although the Securities and Exchange Commission's passage of Rule 415 in early 1982—allowing the so-called "shelf registrations"—enabled issuers to tap the U.S. markets almost instantaneously, it took a while for firms to take advantage of this rule.

A third force affecting the two markets in 1982 was a shift in the demand of foreign investors for dollar-denominated bonds relative to that of U.S. investors. During much of 1982, even when the domestic bond

market was in the doldrums, the foreign-investor demand for these bonds rose sharply—in large part reflecting their beliefs both that U.S. interest rates would fall and that the dollar would weaken against the yen, mark, and Swiss franc. However, owing in part to the withholding-tax laws in their own countries, these investors preferred to hold Eurodollar bonds rather than domestic U.S. bonds. As a result, the demand for Eurodollar bonds rose relative to that for U.S. bonds, driving down relative Eurobond rates. Lured by the cheaper source of financing, American companies issued Eurobonds in record numbers. And eventually the yield advantage vanished—albeit with somewhat of a delay.

Clearly, the international bond markets will continue to provide U.S. corporations with an additional source of long-term funds in the future. However, the growth in the use of this market in 1983 will probably be somewhat more moderate than in 1982. One of the reasons for this is that, at present, the yield advantage issuers gain by tapping the Eurobond market has disappeared. Moreover, the growth and maturation of the markets—and the increase in the number of potential issuers—suggests that such yield differentials are less likely to occur in the future—and certainly not for as extended a time.

Another reason to expect slower growth is that American firms have become more comfortable with shelf registrations and have been increasingly using them to tap the domestic bond market. U.S. companies are also raising funds in the equity market at an extraordinary pace, taking advantage of the optimism imbedded in current high stock prices.

Even if such slower growth occurs, however, it seems clear that the international bond markets are now too important for U.S. corporate treasurers—or credit market analysts—to ignore.

Thomas A. Lawler

Quarterly Euromarket Report

(\$ billion, end of period)

Total Market Size	IVQ/81	IQ/82	IIQ/82	IIIQ/82	1979	1980	1981
Gross Size (Claims)	1,550.2	1,559.2	1,570.9	1,627.1	1,111.0	1,321.9	1,550.2
Net Size (Claims)	945.0	945.0	965.0	985.0	665.0	810.0	945.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	303.2	303.8	310.4	311.6	269.7	287.5	303.2
Liabilities to Private							
Nonbank Foreigners	94.3	97.0	105.7	107.1	65.9	75.0	94.3
Total Claims on Foreigners	445.7	457.0	469.9	480.5	324.2	385.4	445.7
Claims on Foreign Public Borrowers	59.4	60.0	65.3	67.0	42.0	48.9	59.4
Claims on Foreign Private							
Nonbank Borrowers	161.3	162.8	165.2	166.7	117.8	139.9	161.3

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches. Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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Will France's Policy Shift Be Enough?

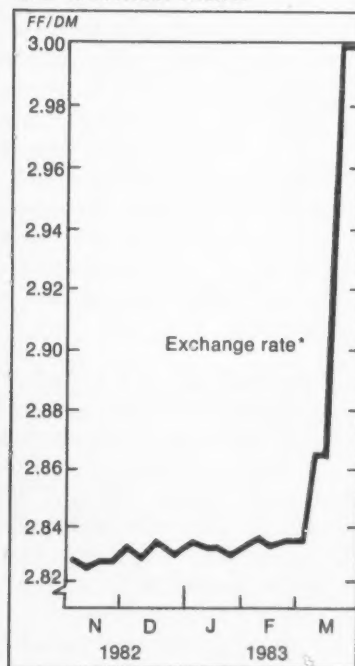
Last month's realignment of central rates in the European Monetary System (EMS) came as no surprise to the financial markets, well acquainted with the fundamental economic policy differences that had arisen between France and Germany.

France's strategy since 1981 had centered on stimulating economic activity through stepped-up deficit spending and increases in consumer purchasing power, with inflation suppressed via wage and price controls. The result was some continued growth but a skyrocketing of domestic credit expansion, as the higher public-sector deficit combined with the increased financing needs of a private sector whose profitability was severely squeezed. In Germany, by contrast, fiscal policy was tightened and, at least until recently, monetary policy remained relatively restrictive. As a consequence, France had large deficits in the current and private-capital accounts of the balance of payments while Germany had surpluses in both. In this environment the French authorities were effectively left with only two choices—a significant increase in the franc price of the mark or a Draconian cut in France's rate of monetary expansion. And given the rigidity of nominal wages, the latter course would have implied unacceptably high costs in terms of unemployment.

Without a shift in policy, last month's 8% devaluation of the franc in terms of the mark would probably not have been sufficient to prevent strains in the EMS from reemerging later in the year. Shortly after the change in EMS parities, however, Finance Minister Delors unveiled a tough package of public spending cuts, higher taxes, increased public-sector prices, and forced savings designed to reduce domestic demand this year by 2% in real terms. In addition, the 1983 target for M2 growth was cut from 10% to 9%, against a provisional estimate of 12.2% growth in 1982. As a result, although France will be lucky to see any real growth this year, the current-account deficit should decline sharply and the present EMS franc/mark rate seems likely to hold into 1984.

Assuming unchanged policy in Germany, how long this parity can be maintained depends on France's ability and willingness to reduce the rate of domestically generated monetary expansion. The costs in terms of foregone output and unemployment of such a monetary tightening vary inversely with the policymakers' ability to dampen wage increases and reduce real labor costs. Thus, the key to the franc/mark rate next year hinges on how successful the Mitterand government will be in its efforts to inject a more realistic attitude into French expectations of real wages.

The French franc price of the German mark



*Weekly average of daily figures

*Stronger
Swiss franc
ahead.*

The Swiss franc slipped against the German mark in recent weeks, from 0.82 in January to a low of 0.87 in mid-March. Some of this fall reflected the mark's rise in anticipation of a formal realignment within the EMS and caused little concern to the authorities. As expected, the franc recovered somewhat once the realignment was actually announced. Nevertheless, the Swiss National Bank tightened its policy stance a little in order to narrow the gap between German and Swiss interest rates and thus guard against any further exchange-rate slippage. Looking further ahead, there is a good chance that the Swiss franc will appreciate again: Swiss economic growth is likely to lag behind Germany's and so give the country a substantial current-account surplus. Furthermore, the pressures that kept Swiss inflation above that of Germany for 10 months appear to be subsiding, which should enable Switzerland to once again enjoy the lowest inflation rate in Europe.

*Unexpected devaluation
of Dutch guilder
likely to spur
interest-rate decline.*

The major, in fact the only, surprise of the recent EMS realignment was the 2% devaluation of the Dutch guilder relative to the German mark—a move not justified by economic fundamentals. Holland's inflation rate has been virtually identical to Germany's and, on the basis of unit labor costs, Holland has actually gained in competitiveness vis-à-vis Germany over the past two years. Moreover, the Netherlands has a massive current-account surplus, which in 1982 amounted to more than 4% of GDP. Given the country's fairly restrictive fiscal stance and now even-more-improved competitive position, another rise in the current-account surplus is forecast for 1983. At present, the guilder is expected to come under upward pressure in the EMS over most of 1983. And this suggests a decline in Dutch interest rates relative to those in Germany.

*Sweden hoping
to maintain
single-digit inflation.*

After long and difficult negotiations, Swedish labor organizations last month finally reached agreement on 1983 wage increases. With the devaluation of the krona last October, Sweden's Social Democratic government accepted the fact that inflation would be given an upward push. But at the same time, the policy-makers warned that if the move was to have beneficial effects, the initial inflation pressures should not give rise to compensating pay increases. The latest settlements allow for a 1.9% rise, which, taken together with arrangements made under previous agreements, should hold the increase in earnings to some 8.4% for the year. This means that, although it has no hope of matching the low rates of inflation seen in Germany or Switzerland, Sweden should be able to keep its 1983 inflation rate in single digits after last year's 8.8%, which followed 12.1% and 13.7% in 1981 and 1980, respectively. Other aspects of the economy also look more encouraging: After almost no growth in 1982, GDP is expected to record a 1.8% rise this year with every prospect of a still higher figure next year. In addition, the current-account deficit should narrow from 1982's \$3.6 billion shortfall and, as a result, help to reduce Sweden's overseas borrowing needs.

*Devaluation and
fiscal stringency
in Ecuador.*

Ecuador has devalued the sucre and reduced the fiscal deficit in a dual effort to promote exports and restrain import demand. The official exchange rate has been set at 42 sucres per U.S. dollar, down from 33, with further regular adjustments to be made subsequently. In addition, 30% of non-traditional exports are now permitted to be cleared on the free-exchange-rate market, which as of last week was quoted at 82 sucres per dollar. Imports are being restricted through direct measures and by putting more items also on the free market. The government is also using demand management measures to dampen both imports and the inflationary pressures resulting from the devaluation. Policymakers are aiming to keep budget growth limited to 5% per year—despite high inflation expectations—and much public-sector employment has been frozen. The intent of these measures is to reduce the country's current-account deficit, which, because of falling oil export income, widened to \$1.2 billion last year. Reduction of the deficit is urgent in view of the currently low, \$150-million level of international reserves and the need to refinance much of the country's public-sector external debt.

*Canadian economy
still waiting
for an upturn.*

Recently released statistics on the Canadian economy have demonstrated just how bad the past year was—and how uncertain the future still is. A 4.8% drop in real GNP last year indicated that, among developed countries, Canada was one of the hardest hit by the world recession. However, despite the sharp curtailment of economic activity Canadian inflation pressures remained virulent, with the GNP deflator posting a 10.6% rise. Although some signs of a recovery have recently emerged, the data are not positive enough to say that a rebound is definitely under way. Industrial production is still sluggish, and unemployment is still uncomfortably high at 12.5%. Moreover, housing starts have recently eased from their sharp increase in January. New manufacturing orders, as well, have not shown consistent growth. The soon-to-be-released federal budget will most likely show a large deficit to be financed, which might limit the extent of interest-rate declines. On balance, the worst is over for Canada, but better times are still more of a hope than a reality.

*Australian devaluation
promises balance-of-
payments improvements.*

Newly elected Australian Prime Minister Hawke's first major policy move was to devalue the Australian dollar by 10%. This will reduce the trade deficit—previously forecast to be at least \$5 billion this year—by slowing imports and boosting exports. Hawke's alternative was to exhaust the country's reserves in what probably would have proven to be a futile effort to prevent the Australian dollar from declining; such a course, at best, would have merely delayed the inevitable exchange-rate adjustment. Devaluation will not only defend reserves, but also should produce a stable or even slightly appreciating Australian dollar in 1983. A stronger currency will encourage capital inflows, which could prove even more important to the Australian balance of payments than the improvement in the trade account that the devaluation will also engineer. The only danger in the devaluation is that it could worsen the already serious problem of inflation—the root cause of the Australian dollar's weakness in the first place.

*New fiscal year
marks tax-law
changes in India.*

India's recently announced budget for fiscal 1983/84 starting April 1 aims to encourage production and promote saving and investment while containing the deficit. Development spending is slated to increase 21%, but total spending is expected to rise by only 10%. Additional taxation of 7.16 billion rupees has been proposed, including a five-percentage-point increase in the auxiliary customs duty. This comes on top of a major extra-budgetary fund-raising effort that included sharp increases in petroleum prices and railway rates, along with higher postal and telecommunications tariffs. A minimum corporate tax has been levied and the corporate surcharge increased. But business has also been granted increased depreciation allowances and excise-duty concessions for higher production. In addition, tax concessions to nonresident Indians remitting savings for investment at home have been liberalized considerably. The net result is a projected overall budget deficit of 108.1 billion rupees, compared with 106.8 billion rupees in 1982/83.

*Rising import demand
could lead to reversal
of Kenya's current-
account gains.*

Even though the decline in Kenya's terms of trade appears to have been arrested, the downtrend in the country's current-account deficit since 1981—to around \$400 million this year—could easily be reversed in 1984 because of the need for increased imports. And because there appears to be no relief in sight from a severe foreign-exchange shortage, the country will have to face some difficult decisions over the near term. Some funds could be freed by diverting multilateral and bilateral loan commitments from project financing to balance-of-payments support. However, such a move would constrain development and economic growth at a time when per-capita real incomes are continuing to decline. Also, it is unlikely that any moves that would further increase debt-service obligations—already forecast to top 25% of foreign-exchange earnings in 1984—represent a viable option. Thus, Kenya can be expected to join the ranks of sub-Saharan nations experiencing an increased dependence on foreign donors for financial support on softened terms.

Social Security—Avoiding the Inevitable

Although there is still no consensus on Capitol Hill about how—or even whether—the overall budget deficit should be narrowed, Congress last month exhibited rare unanimity and speed in addressing the financial problems of the Social Security system. Legislation was enacted to close the \$150-200 billion funding shortfall expected to be incurred over the balance of the 1980s. But while this legislation has been widely acclaimed for putting Social Security back on firm ground, the system's problems are far from solved.

Concerns about the long-range financial viability of the Social Security system started to emerge in the mid-1970s. The ratio of trust-fund reserves to annual expenditures fell below 100% for the first time in 1972, and below 50% in 1977. The drawdown in reserves was the result of a 20% increase in benefits in 1972 and the advent of indexation of payouts in 1975—without compensating increases in taxation. More important, estimates of the future unfunded liabilities of the system increased by more than twelvefold, from just over \$400 billion in 1972 to a staggering \$5 trillion in 1977.

Legislation in 1977 attempted to correct these financial difficulties. Both the tax rate and the wage base to which the rate applies were raised over and

above the increases that already had been scheduled. However, even these hikes were not large enough to stop the decline in reserves. Moreover, unfunded liabilities fell by only 25%.

The recessions of 1980 and 1981-82 turned Social Security's chronic problems into painfully acute stresses that threatened the government's ability to keep the checks going out each month. Receipts fell behind as employment declined, and higher-than-expected inflation rapidly drove up expenditures. As a result, reserves dwindled to less than two months of outlays, barely sufficient to cover seasonal shortfalls in receipts. And the unfunded future liabilities of the system soared to more than \$6 trillion.

Amidst this sort of crisis atmosphere—not to mention Congressional elections—a blue-ribbon commission on Social Security reform, appointed by President Reagan, eventually was able to reach a bipartisan consensus to alleviate the immediate financial strain. The commission recommended and Congress enacted a whole host of tax increases and benefit reductions that spread the costs of "saving" Social Security across an extremely wide spectrum. Still, however, the legislation is generally incremental in nature. More radical solutions such as making Social Security a voluntary program, converting it to a fully-funded pension pro-

gram, or changing it to be "need-based" were rejected.

The highlights of the recent legislation fall into three main categories:

Tax increases

- Raise 1984 payroll tax rates by 0.3 percentage points for both employers and employees; accelerate part of scheduled 1990 increases to 1988.
- Raise the Social Security tax for self-employed individuals by one-third.
- Extend coverage to all new federal employees and all employees of nonprofit organizations; prohibit withdrawals by state and local governments.

Benefit decreases

- Postpone July's scheduled cost-of-living adjustment to January 1984; no future adjustments if the annual increase in the Consumer Price Index (CPI) is less than 3%.
- Use the lower of a wage index or the CPI if reserves fall below 20% of annual expenditures.

Infusions of general revenues

- Allow individuals a credit against income taxes equal to their payroll tax rate increase in 1984.
- Allow 50% of tax paid by self-employed persons to be deductible against income (not deductible under previous law).
- Tax the benefits of recipients earning above certain income levels, with proceeds turned over to the trust fund.

Unfortunately, as it has in the past, Congress focused on the short-run solvency of the Social Se-

curity system, without fully addressing its longer-run health. For example, extending the system's coverage to make it nearly universal brings in a lot of revenue in the short run, but also adds significantly to the long-run liabilities.

The legislation's one significant departure from past tradition involves the direct and indirect infusion of general tax revenue into Social Security. Proponents of such transfers argue that they are long overdue, citing the fact that surpluses in the earlier years of the program's existence had helped finance overall budget deficits. On the other hand, opponents contend that transferring general tax revenue into the trust funds compromises Social Security as a retirement program and emphasizes its income redistribution aspects.

In response to this initial "commingling" of funds, pressures to remove the Social Security Administration from the unified budget or to give it independent-agency status can be expected to increase. The reform commission itself recommended such a move, and a study on the issue of agency status was mandated in the legislation. If either of these actions is successful in limiting the use of general revenue in the future, the Social Security system may well have to undergo the radical transformation that was so carefully avoided in the latest legislation. And the staggering burden of the program's unfunded liabilities will force choices between tax increases and benefit reductions that have thus far been too painful to make.

Douglas L. Bendi

Asia and Oceania Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		6 months ending	12-month change	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars April 6, 1983	change from year earlier		current monetary conditions
												latest data	consumer prices	latest data	money supply(M1)				
Bangladesh	Government estimates real growth at 4% for fiscal year ending June 30th.	Dec.	+12%	10.8*	120	Feb.	197	— 8%	1.1	407	New aid commitments totaling \$2.2 billion being sought for 1983/84.	Dec.	+ 5%	Nov.	+ 6%	.0415	—20%	IMF loan of \$73.8 million received.	Bangladesh
Burma	Fuel shortages arising from decline in domestic oil production constraining economic activity.	Dec.	—29%	5.8*	159	Feb.	56	— 75%	1.9	71	Depressed commodity markets cause exports to fall 40% below target.	Dec.	+ 4%	Aug.	+ 8%	.1317	— 2%	Kyat peg causing official and black market rates to diverge.	Burma
China, People's Republic	Industrial growth of 7.4%, record grain harvest of 344 million metric tons posted in 1982.	Dec.	+ 3%	260.0	260	Sept.	9,444	+140%	6.7	492	Import growth accelerating after unprecedented \$4.6 billion trade surplus.	Dec. '81	+ 3%	Sept.	+12%	.5151	— 8%	Investment growth to boost deficits in 1983.	China, People's Republic
Hong Kong	Budget deficit of HK\$3.2 billion forecast for 1983/84.	Jan.	+ 2%	24.2	4,695	n. a.	—	—	—	—	Exports expected to rise about 7% this year.	Jan.	+10%	Jan.	+ 5%	.1490	—13%	Money growth modest, but rates are down.	Hong Kong
India	Budget for fiscal 1983/84 provides incentives for production, investment, and savings.	Sept.	— 9%	161.4*	236	July	4,524	— 16%	4.4	2,279	Auxiliary customs duties raised; incentives given for remittances, exports.	Oct.	+ 7%	April	+ 9%	.1000	—16%	Interest rates cut 150 basis points.	India
Indonesia	Government spending likely to be cut in line with new oil prices.	Aug.	—15%	81.5	541	Jan.	3,060	— 44%	2.3	71	Rupiah maxi-devaluation will improve current account, stem reserve outflow.	Jan.	+10%	Oct.	+22%	.00103	—35%	Tighter credit conditions likely.	Indonesia
Japan	Stimulus measures announced as unemployment in January reached all-time high.	Jan.	+13%	1,142.0	9,707	Feb.	23,930	— 14%	2.3	0	Exports begin to show signs of possible revival.	Feb.	+ 2%	Jan.	+ 3%	.00421	+ 3%	Pressure builds for discount-rate cut despite yen weakness.	Japan
Korea	Export-led recovery looks possible in 1983.	Jan.	+ 1%	62.3	1,610	Feb.	2,378	— 16%	1.2	1,244	World recovery should help current account.	March	+ 5%	Nov.	+53%	.00132	— 7%	Authorities slow rapid increase in monetary aggregates.	Korea
Malaysia	Government projecting real growth of 4.5% in 1983.	Nov.	+10%	24.0	1,666	Jan.	3,755	— 9%	3.6	271	Export volume increased to offset \$5.50/barrel crude-oil price cut.	Dec.	+ 5%	Dec.	+13%	.4376	+ 2%	Interest rates decline.	Malaysia
Nepal	Food production reported 20%-25% short of target owing to poor weather.	Dec.	—45%	2.5*	165	Feb.	184	— 7%	5.4	14	Ruppee steady after January devaluation.	Dec.	+10%	Aug.	+12%	.0699	— 8%	Liberal credit policies adopted.	Nepal
Pakistan	Prospects good for record wheat crop.	Dec.	—10%	30.9*	360	Feb.	1,343	+ 90%	3.1	1,334	Ruppee depreciation aiding nontraditional exports, but rice prices down sharply.	Jan.	+ 5%	Dec.	+20%	.0710	—30%	Drawing under IMF Extended Fund Facility resumed.	Pakistan
Philippines	Drought and government austerity measures depressing activity.	Oct.	—10%	38.7	781	Feb.	1,464	— 27%	2.1	807	Commodity-price recovery, oil-price and interest-rate declines improve outlook.	Dec.	+ 7%	Jan.	+ 4%	.1030	—15%	Domestic credit expansion to be held to 20%.	Philippines
Singapore	World recession finally hits home.	Dec.	— 5%	12.5	5,121	Nov.	8,023†	+ 7%	3.5	0	Reserves rising despite export slowdown.	Jan.	0	Nov.	+14%	.4739	+ 1%	Money-supply growth rapid and interest rates falling.	Singapore
Sri Lanka	Budget calls for sharply higher government spending, increase in Business Turnover Tax.	Nov.	—11%	4.4	294	Feb.	293	— 3%	1.8	345	Import duties raised sharply.	Jan.	+ 6%	Oct.	+20%	.0437	—13%	Planned budget deficit large, but bank borrowing small.	Sri Lanka
Taiwan	Business conditions likely to improve with world recovery.	Sept.	+ 3%	46.0	2,559	Sept.	7,897	+ 51%	5.1	0	Reserves rising extremely rapidly.	Sept.	+ 2%	Sept.	+21%	.0250	—11%	Money-supply growth is robust.	Taiwan
Thailand	Production from Shell oil field lower than expected; gas production remains disappointing.	Dec.	— 8%	36.1	750	Feb.	1,561	+ 11%	2.2	692	Poor 1982 crops, EEC tapioca quota depressing exports.	Feb.	+ 3%	Sept.	+11%	.0430	— 7%	Real rates remain extremely high.	Thailand
Australia	End of drought and impending world recovery promise boost in economic activity.	Dec.	— 2%	158.0	10,632	Feb.	5,691	+350%	2.7	35	Devaluation will improve current account, encourage capital inflows.	Dec.	+11%	Jan.	+ 1%	.8671	—17%	Interest rate spike before devaluation reversed.	Australia
New Zealand	True recovery awaits rises in wool and mutton prices.	Dec.	+ 1%	23.5*	7,510	Feb.	814	+ 93%	1.8	3	Lamb prices down 15% in 1982.	Dec.	+15%	Jan.	+ 2%	.6560	—14%	Money-supply growth is robust.	New Zealand

*Fiscal year

†Includes gold holdings

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World Interest Rates

market rates as of April 6, 1983; bond yields as of April 1, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.42	10.563 intervention rate	11.00	9.50	4.00	18.00 penalty rate 21.00	3.50	4.00	5.50
Day-to-Day Money	8.75 April 7	9.25	10.625	12.00	12.75	5.05	19.25	4.00	4.25 1-month Euro-Swiss fr. rate	6.625
Treasury Bills 91-day, Middle Rates	8.63	9.20	9.938	11.40	n. a.	n. a.	17.50 85 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	9.125 finance paper discount basis	9.45 finance paper 15% tax w/h	10.06	10.90 Certified	12.50 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.75	9.35 15% tax w/h	9.813	10.90 Certified	not traded	5.30	19.30	no market	4.125	no market
Government Bonds Long-term, new and old issues, average yield	10.85	11.90	10.61	10.45	13.73	7.55	18.67	7.81	4.48	7.072
Industrial Bonds prime, long-term, new and old issues, average yield	11.65 Aa Industriels	12.75	12.34	12.38	14.99	7.60	18.04	8.19	5.79	6.43
Bank Short-Term Rate (prime rate)	10.50	11.50	10.50	15.00	14.55	8.00	19.50 1/4 qtrly fee on outstndg.	6.00	7.50	6.00
Bank Time Deposits 3-month	8.75 Cert. of Dep.	9.063	10.188	12.00	12.50	5.05	11.50	4.375 large deposits	2.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.625	9.668	10.438	no market	15.375	5.125	no market	4.563	4.063	6.50
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8104	1.514	.0209	.1384	.4148	.0007	.3684	.4882	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.049 P	.528 D	2.359 D	4.913 D	4.629 P	8.606 D	5.320 P	5.653 P	3.126 P
Eurodollar Deposits (London, interbank, bid) April 7		International Arbitrage (3-month, hedged) + in favor of U.S. dollars				Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under Over 7 yrs. DM Bonds 7 yrs. and under Over 7 yrs.			Gold Price London afternoon fixing	
7-day 9.313		U.S.-U.K. Treasury Bills —0.644				10.75				
1-month 9.375		U.S.-Canada Treasury Bills —0.289				11.00				
3-month 9.375		U.S.-Canada Finance Co. Paper —0.244				7.50			428.50	
6-month 9.50		Eurodollars-U.K. Local Auth. Deposits —0.034				7.75			(per fine ounce)	

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Feb.) 3.5	(Feb.) 7.4	(Feb.) 5.3	(Feb.) 9.2	(Mar.) 3.5	(Mar.) 16.4	(Feb.) 4.8	(Mar.) 2.5
Industrial production*	(Feb.) -3.9	(Jan.) -6.2	(Jan.) 2.2	(Jan.) -1.6	(Jan.) -1.9	(Jan.) -4.9	(Sept.) -8.0	(Feb.) -1.7
Trade balance† (billions of local currency units)	(Feb.) -\$3.58	(Feb.) C\$1.44	(Feb.) -£0.14	(Feb.) -FF7.60	(Feb.) DM3.70	(Jan.) -Lit.2,620	(Feb.) -SF0.70	(Feb.) ¥507.9
Money supply (M1)*	(Feb.) 8.9	(Feb.) 9.6	(Jan.) 10.2	(Nov.) 12.0	(Jan.) 9.3	(Oct.) 15.1	(Dec.) 10.9	(Jan.) 7.3
Velocity of money (M1)*	(Dec.) -4.9	(Sept.) 0.8	(Sept.)** -4.6	(June)** 2.2	(Dec.) -3.8	(Sept.)** 2.8	(Mar.)** 9.3	(Sept.) 0.1
Reserves minus gold (3 million, change from previous month)	(Jan.) -18	(Jan.) 330	(Jan.) -1,559	(Jan.) 2,945	(Jan.) 1,395	(Jan.) 1,149	(Jan.) -2,709	(Jan.) 329

* Percent change from 12 months earlier.

** based on GDP.

† Figures are only for the month indicated.

Williamsburg: The Road Back to Bretton Woods?

A fundamental reassessment of the world's experience with floating exchange rates is under way—ironically coinciding with the 10th anniversary of the demise of the Bretton Woods system of fixed exchange rates. Out of the economic summit meeting in Versailles last summer came a study, coordinated by the U.S. Treasury, on the experience with intervention by all central banks over the last decade. It reached an essentially neutral conclusion. Since then, however, reports on the purported virtues of intervention have been coming in thick and fast—with a favorable study by the Federal Reserve now nearing completion. The political pressures for intervention are overwhelming. And agreement on the principle of a return to active, coordinated intervention by all the major central banks—with “target zones” for the world's key currencies—now appears certain to come out of this year's summit meeting in Williamsburg, Virginia, at the end of May.

The rationale for a return to more-stable currencies is straightforward: Exchange-rate fluctuations have simply become too volatile, carrying too high a social cost. This experience contrasts with the optimism prior to the shift to floating rates in the early 1970s, when economic theorists were predicting that such a move would lead to three developments:

- First, exchange rates would adjust continuously and smoothly to new information and thus provide an equilibrating force that would harmonize the world economies. This view was based on the belief that the foreign-exchange market is efficient and would thus discount all new information and forecasts. Shocks to the market would come only from wholly unforecastable events, such as central bank intervention or wars.
- Second, purely floating exchange rates would restore monetary independence to individual countries. Under a fixed-exchange-rate regime a central bank is obligated to exchange any volume of foreign currency into its own currency. The experience during the late 1960s was that because of the persistent U.S. balance-of-payments deficit, the Bundesbank was continuously being forced to exchange dollars for marks. This led to high growth in the German money supply and consequently increased German inflation—and to European accusations that the United States was “exporting” inflation.
- Third, floating exchange rates would reduce the dollar's dominance over the world monetary system. Independent financial markets would develop, providing genuinely separate financing and investment media. This prediction spurred hopes that the world would evolve toward a multiple-reserve-currency system, with the possible emergence of a “world currency” along the lines of what later became the IMF's Special Drawing Rights.

Unfortunately, none of these theoretical predictions have proved to be valid. Exchange rates have become progressively more variable. Analysis based on so-called “economic fundamentals” has failed to forecast, for example, the persistent 20% overvaluation of U.S.-traded goods above Japanese goods prices. However, models based on currency substitution *have* forecast this—in contradiction to the instantaneous discounting of efficient-markets theory. Short-run volatility has also increased enormously. It is now common to have one-percentage-point moves in major currency values overnight. And these fluctuations tend to turn into trends—witness the 20% decline in the dollar relative to the yen in the last eight weeks of 1982.

Furthermore, monetary independence is virtually non-existent because of the continued de-facto dominance of the world monetary system by the dollar. For example, if the Fed tightens monetary policy aggressively at a time when another country is easing its policy, then there will be a major shift of investment into the dollar and a shift of borrowing into the other currency. In fact, these shifts in the currency denomination of asset and liability preference are now the moving force behind changes in currency values.

Is intervention the answer?

The predominant view of economic theorists used to be that the foreign-exchange market in the major freely traded currencies is “efficient.” This means that: (1) information on all forces affecting the market is available at low cost, (2) there are very few barriers to entry to the marketplace, and (3) there are no dominant participants in the market. In such a market all known information and forecasts are instantaneously reflected in the current exchange rates.

One major corollary to this statement, which can be statistically tested, is that there should never be discernible trends in currencies that can be traded upon consistently for profit—at low risk. If there were, for example, a clear uptrend in the dollar, then speculators would immediately buy the dollar, pushing it up to the point where the best guess of the next move is—sideways. In fact, however, the history of floating exchange rates disproves this. Low risk currency trends do exist—and persist.

From the perspective of efficient-markets theory, central bank intervention can be effective in changing trends only if either (a) the intervention is so heavy that it destroys market efficiency, or (b) the intervention is based on more perfect insights into future developments than the combined judgment of the market participants.

According to the theorists, the acid test of effective foreign-exchange intervention is whether it turns out to

Williamsburg: The Road Back to Bretton Woods? *(continued from page 7)*

be profitable—and not just in terms of one currency. If it is profitable, then the insights of the intervening central bank were correct; thus, the intervention gave the correct signals to the market and speeded the move toward a new equilibrium. If the intervention is unprofitable, then the central bank will have merely sidetracked the market and postponed making needed adjustments in domestic policies. In the vast majority of historical studies on intervention, the latter proved to be the case: Intervention was unprofitable and largely undertaken with the forlorn hope that an adjustment in domestic policies would not be required.

Furthermore, both risk and the potential future costs of policy flexibility must also be taken into account. For example, it is clearly possible for a central bank to fix an exchange rate at any value for any period of time. But if the rate chosen is out of line with the private market's view, then such a policy carries with it extremely high risks—not only that the free markets will be severely distorted, but also that a large part of the populace will be put out of a job by the central bank's attempt to hold the rate. Even if intervention is profitable with no major immediate indirect costs, the costs of acquiring and holding foreign-exchange reserves may deeply compromise future policy flexibility. In the extreme situation—which unfortunately does occur—a near-total loss of reserves can subsequently lead to spiraling devaluation and severe disruption of the economy.

Target zones—the first step

Although most of the earlier studies on intervention suggest it is valueless or disruptive, the fact is that the implicit intent of almost all intervention actions in the past was to postpone or avoid domestic policy actions—not to solve problems in the foreign-currency markets *per se*. For instance, the failed intervention to support the dollar during 1976-78 was, in reality, an attempt by the United States to postpone the politically painful process of raising the U.S. gasoline price to the world price level—and in that it was, of course, successful.

The fact that the one-percentage-point overnight currency moves are disruptive to world commerce provides interventionists a *prima facie* case for intervention to stabilize short-run exchange-market fluctuations. The most popular proposal at present is the target-zone idea: Central banks would intervene flexibly on both sides of a pre-agreed but unannounced band that would move over time. The theory is that the visible presence of the central banks would eliminate the tendency for currency "runs" to occur. This would enable "regressive," or stabilizing, expectations to emerge and, by reducing the high uncertainty premium, encourage longer-term stabilizing speculations.

The proponents of intervention see this as a first step back toward Bretton Woods—back to fixed exchange rates with a role for gold. However, except in the aftermath of world financial crisis, a return to fixed exchange relationships maintained by intervention is simply not feasible. There are three main reasons for this:

- First, the volume of potential arbitrage would overwhelm the total reserves of all the central banks. If exchange rates are fixed for even one month, all the one-month interest rates will be forced into instant equality with incredibly large capital flows—perhaps more than \$50 billion by major U.S. financial institutions alone in the first two weeks. The clearing interest rate in such a world would be primarily set—as it currently is—by the deepest market: the dollar market. This would leave real interest rates in different markets in acute disequilibria and would severely tax employment in countries with inflation rates lower than that of the United States, to the benefit of higher-inflation countries. This would be totally unacceptable to politicians who want harmonized policies, but at no cost.
- Second, real exchange rates have been at such acute disequilibria over the past five years that there has been a massive redistribution of worldwide production. As a result, there are now self-perpetuating instabilities that would overwhelm intervention. Thus if the dollar is permanently fixed at current levels, then large sectors of U.S. manufacturing industry may never recover.
- Third and finally, there is arithmetic to contend with. In principle, the balances of payments of all countries must sum to zero (in practice, they do not because of measurement errors); someone's surplus must be matched by another country's deficit. If all countries try to achieve a payments surplus, at least one country must lose. Since the dollar enjoys the role of world money, it is the primary buffer for disequilibrium in the international balance of payments.

Seen in this light, intervention between the major asset currencies is madness. But logic and experience have never been a powerful motivating force behind political decisions. Central banks exist to intervene and control free markets. They have to operate on the belief that they are privy to unique and deeper insights than the free market—and that they are not the source of instability. Otherwise they have no *raison d'être*. Central banks realize that a return to fixed exchange rates is currently a technical and political impossibility. Nevertheless, the lure of the power to intervene and to "stabilize" the world economy is too great to be resisted. Hence, a move back to active, coordinated intervention by the major central banks seems to be politically inevitable.

Ronald G. Layard-Liesching

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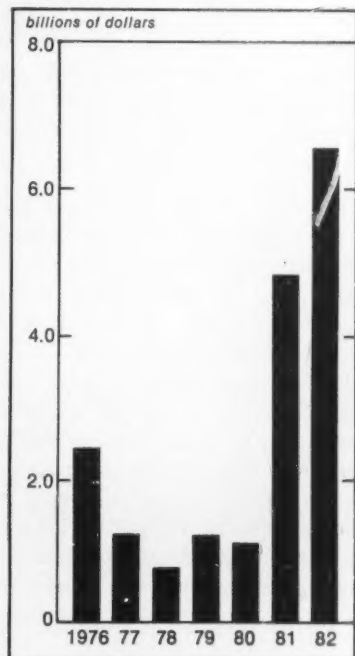
Is U.S. Money Growth A Foreign Affair?

The instability of U.S. money growth has been highly disturbing to economists and other analysts who favor close control of the domestic monetary aggregates. But their fears may stem more from the narrowness of their own assumptions than from any faulty execution of monetary policy. In its strictest form, this approach assumes that the target aggregates—M1 and M2, for example—reflect only the money holdings of U.S. residents. Furthermore, all of the money balances held by these residents are included in the domestic aggregates. No allowances are made for the effects of either currency substitution or “haven-currency” demand for dollar-denominated assets. Strict aggregates targeting thus fails to consider that residents may not always want to hold their assets in dollars and that non-resident holdings of dollar assets may constitute a significant portion of the domestic money stock. These assumptions need reconsideration. The shifts in asset preferences that have produced the wide swings in the foreign-exchange value of the dollar in recent years may well have been a major force behind the puzzling variability of U.S. money growth. (See page 7.)

For example, the increased “dollarization” of many developing economies—particularly Latin America—has certainly contributed to the rapid increase of U.S. monetary aggregates over the past year or so. The question is whether the effects of such shifts have been important. Unfortunately, this is not easy to determine from the information at hand. Data on foreign ownership of U.S. bank liabilities appear to be highly incomplete. And figures on resident holdings of monetary assets denominated in other currencies—and on the volume of U.S. currency in circulation abroad—are simply not available. The best that can be said is that the existing data are not inconsistent with the hypothesis that the currency preferences of both residents and non-residents are subject to significant swings that are related to the expected foreign-exchange value of the dollar.

These effects may also be important in explaining the behavior of U.S. money growth. The best evidence of this is that changes in U.S. domestic monetary aggregates provide a less complete explanation of changes in U.S. inflation than do changes in a more-comprehensive monetary measure—one including information on changes in domestic money stocks in other major-currency countries. This result also holds for the other major industrialized countries. Money clearly matters. It matters a lot. But the measure of money that matters the most in an era of highly interconnected capital markets is a wider concept than that captured in conventional domestic monetary statistics.

Changes in private, non-bank foreign deposits in U.S. banks*



*net of International Banking Facility liabilities

*British pound recovers
but remains
on shaky ground.*

After some days trading close to a record low of \$1.45, British sterling has risen steadily since the Easter weekend and, according to some pundits, is set to climb still further in the near term. To some extent, this rebound reflects sterling's status as a petrocurrency. There are a few signs that the downward pressure on oil prices has eased for the time being, reducing the chances of the uncontrolled fall in prices some observers had been predicting. However, there have been other forces behind sterling's resurrection: The domestic economy is now rebounding quite smartly—industrial production in March was up 2.9% from a year ago—and the business community has become markedly more optimistic. The current account is back in surplus after January's unexpected deficit. Moreover, the inflation rate is already down to a year-on-year rate of 5% and is set to fall still further soon. Furthermore, opinion polls continue to suggest that Mrs. Thatcher's government will be returned in the next election. Nonetheless, sterling remains somewhat risky. Oil prices are still far from stable. And on the domestic front, industrial unrest seems to be on the rise again after two relatively quiet years; this could shift opinion against the government. Finally, there is still no definite word on the election date. And uncertainties over the timing and the outcome of that event could yield substantial swings in the exchange rate over the next few months.

*Economic recovery
still fragile
in Germany.*

Recent economic statistics show that Germany's recession has bottomed out and that output is on the rise. Closer inspection of the data, however, suggests that, while the economy has indeed passed the trough, the extent of an upturn is still uncertain. Industrial production during the first two months of 1983 averaged only about 1.5% above the low level of the final two months of last year. Total industrial order volume was also up 1.5%, with a 0.5% rise in domestic orders and a 4.2% upturn in foreign orders. Both these components, however, appear to have been overstated—the domestic order picture by several large scale orders as well as the expiration of an investment incentive scheme at year-end 1982, and foreign orders by expectations of a mark revaluation in the European Monetary System. The boost lower interest rates are now giving construction activity and recent improvements in business and consumer confidence offer some encouragement for the outlook. However, consumers' real incomes are expected to decline again this year, and prospects in several of Germany's big export markets look distinctly poor. Thus, exaggerated optimism at this stage in the cycle only risks another consumer and investor retrenchment further down the line.

*No major economic
policy shift expected
from Finland's
new government.*

Finland's March election produced some surprises. It had been clear in advance that support for the Euro-Communist party was declining. But instead of the expected swing toward the Conservative party, most of the gains were enjoyed by the small, farming-based Rural party, and by the "Green" environmental party, which entered parliament for the first time with two seats. The elections produced one of the biggest changes in Finnish history with one-third of the members of the previous parliament eliminated. Prime Minister Sorsa has now resigned, paving the way for President Koivisto to appoint a new government. It is clear that, despite these changes, the new government will continue to be based on a center-left coalition and that there will be no great shift in economic policy. The economy is, in fact, reasonably healthy despite a slowdown in trade with the Soviet Union. Inflation is expected to slow to around 8% in 1983 after last year's 9.3%. And economic growth should pick up toward 2% from 1% in 1982. Furthermore, the current account is expected to record a small surplus this year—the first surplus since 1978. Thus, an unchanged policy stance would seem appropriate.

*Mexico continues
to put its economic
house back in order.*

The Mexican government is persisting in its difficult economic adjustment program, despite a less-than-favorable external environment. Restrictive fiscal-policy measures in the form of higher taxes, lower subsidies, and reduced expenditures have been introduced relatively smoothly. In the meantime, the labor

sector has been unusually cooperative, accepting wage increases that fall well short of the 100%-inflation rate expected for 1983. External conditions may, nevertheless, ruffle the program. First-quarter disarray in the world oil markets seems to have affected Mexican petroleum exports. Preliminary estimates are that oil exports fell to 1.2 million barrels per day (b/d) in February and March—significantly lower than the 1983 official target of 1.5 million b/d. Moreover, although short-term international interest rates are currently below those used in the government's 1983 budget, these rates are holding firm. The general consensus is that they will fall no more than 100 basis points in the next quarter providing little additional relief this year to Mexico's large debt-service burden. Still, if the international oil markets hold firm for the balance of the year, Mexico could go through 1983 with little additional foreign borrowing.

Uruguay embarking on stabilization program to boost economic and financial prospects.

Extremely high real interest rates, reflecting a sharp reduction in foreign capital flows and fears of devaluation, led to an 8.5% drop in real GDP for Uruguay last year. At the same time, the fiscal deficit soared to the equivalent of 12.3% of GDP. In the external area, the current-account deficit rose to \$514 million, chiefly because of higher interest payments on the external debt. The trade deficit actually improved substantially as imports plunged 40% owing to the drop in aggregate demand. To turn the economy's poor performance around, Uruguayan authorities have embarked on an stabilization program for which they are seeking the financial backing of the IMF. The program includes maintenance of a floating exchange rate, a refinancing of the country's short-term external debt, obtaining new money from foreign commercial banks, and most important, an extremely restrictive fiscal policy—the budgetary gap is to be lowered to 3% of GDP in one year.

Sri Lanka's 1983 budget authorizes tax hikes to offset higher spending.

The government of Sri Lanka announced in early March its long-delayed 1983 budget along with estimates of actual expenditures and receipts under the 1982 budget. Estimates put the 1982 deficit at 20.6 billion rupees, or an incredible 20% of GDP, although the shortfall was some 560 million rupees less than had been expected. To finance the gap, the government borrowed some 4 billion rupees from the domestic banking system, just over 1 billion rupees higher than had been originally planned. The 1983 budget provides for a further sizable increase in real spending, particularly in capital expenditures as work under the Mahaweli-Ganga Development Program peaks. To keep the budget deficit manageable, the government plans to raise additional taxes through a hike in the Business Turnover Tax, a sharp increase in import duties, and the elimination of some tax holidays. The net result is expected to be a deficit of 23.4 billion rupees—still extraordinarily large compared with current GDP forecasts. The government hopes to hold bank borrowing for deficit financing to a low 1.36 billion rupees—only 1% of projected total output. Nevertheless, the total public-sector claim on resources will continue to grow.

Soft oil market spells further narrowing of Kuwait's current-account surplus.

Kuwait registered a current-account surplus of an estimated \$7.5 billion last year, down noticeably from 1981's \$13.8 billion. The lower surplus reflected, in part, 9% growth in imports of goods and services as well as transfer payments. But the drop was mainly attributable to a 33% decline in merchandise export revenues to an estimated \$10.5 billion in 1982 because of much lower gross oil exports. Not only did oil output shrink by 26% to a daily average of 828,000 b/d, but also the average official oil price fell by nearly \$3.00 to \$32.30 per barrel. Receipts from service exports—consisting mainly of investment income—came to an estimated \$10.5 billion. Import growth is expected to moderate this year. Nevertheless, although investment income will remain sizable, the current-account surplus will shrink even further in 1983 because of lower oil income. The official oil price has already been cut to \$27.30 per barrel as of March 1, and continued soft demand for oil will probably keep the country's output well below its OPEC-assigned quota of 1.05 million b/d. Accordingly, it is unlikely that Kuwait's surplus will exceed \$5.0-5.5 billion in 1983.

Signs of an Unbalanced Recovery

The U.S. economy expanded at a 3.1% annual rate in the first quarter, according to preliminary data released by the Commerce Department last Wednesday. This quarterly performance was the strongest in two years, raising hopes that the sluggishness that has plagued the economy since 1979 may be coming to an end. But as pleasant the prospects of sustained growth might be, these latest data contain some disquieting hints that the U.S. economy is not all well yet.

First, the good news: The housing recovery has really taken hold. Residential construction rose at an annual rate of 83% in the first quarter, after a solid 40% gain in the fourth quarter of 1982. The most recent outsized increase contributed about two-and-a-half percentage points toward the overall rise in output.

Consumers also chipped-in to the output gain: Real personal-consumption expenditures rose 2.3% at an annual rate, despite a slowdown in the growth of personal income. A sharp deceleration of consumer prices, along with a slight decline in personal savings, made this advance possible.

Business investment also modestly added to the overall increase. After declining 8% during 1982, real nonresidential fixed investment rose at a 2.7% annual rate. However, large gains in just two sectors—transportation equipment and non-office commercial construction—were partially offset by declines in most other sectors.

Finally, the pace of inventory liquidation slowed considerably. This boosted GNP growth, but also slowed the adjustment of inventories to their desired levels.

On the negative side, the trade balance continued to be a drag on the economy. Export volume continued to decline, although at a much slower rate, while import volume jumped sharply. And government nondefense spending posted a large decline.

Adding up all the sectors, the pluses clearly outweigh the minuses, but the recovery is imbalanced. Even with further declines in interest rates, housing is extremely unlikely to repeat such large gains in the months ahead. Indeed, housing starts slipped back a bit in March from their extraordinarily high levels in January and February. Business investment may fall back somewhat, and the foreign-trade sector is likely to remain weak as recovery in the overseas economies lags behind that of the United States. And with inventories closer to their desired level, restocking is not likely to provide as much of a boost unless sales pick up sharply.

As is almost always the case, then, a sustained recovery rests on the ability and willingness of consumers to spend. Recent data on improving consumer confidence and income are encouraging, but the economy is still far too fragile for concerns to be completely laid to rest.

Douglas L. Bendt

New Phone Subsidy Puts Efficiency on Hold

Deregulation of an industry never runs smoothly. The program recently devised by a panel of the Federal Communications Commission (FCC) to ensure continued telephone service in all local areas after the 1984 divestiture of the American Telephone and Telegraph Company (AT&T) may solve one problem in the short run. But it is likely to impede progress toward a more efficient telecommunications system.

The AT&T system originally serviced only densely populated areas while other companies provided service in many of the more-rural areas. Later, AT&T was awarded a virtual monopoly in the provision of long-distance telephone service. In return, the company agreed to provide service to some of the higher-cost rural areas at the same rates as other local areas—their average cost—on the condition that it would be allowed to subsidize its unprofitable local markets with profits from its long-distance operation.

As AT&T grew, federal regulators began to question whether technological innovation in telecommunications might be better promoted through the introduction of more competition. Spurred by this shift in regulatory attitudes, new lower-cost technology, and the high profits of the long-distance segment of the industry, a trend toward increased competition emerged in the 1970s. This led to the 1982 consent decree in which AT&T agreed to divest itself of its local operating companies. Competitors are now able to tap the enormous profits

of the long-distance market without the obligation of providing local service.

The FCC realized, however, that because of the AT&T divestiture, high-cost local exchange services would lose their subsidies, which could lead them to discontinue service in some areas. To ensure that universal telephone service would continue, the FCC panel has proposed that funds for a new subsidy be collected from the profits of all companies competing in the long-distance market. These companies also are to continue to pay access charges for the use of the local telephone networks required to connect individual callers.

The problems with this proposal are many. The current infrastructure of the local telephone networks—with its obsolete system of poles and wires—is expensive and far behind the state of the art in telecommunications technology. Continued subsidies will only reduce the incentives for development of more-efficient, lower-cost systems. Furthermore, as new firms enter the now-competitive long-distance market, its huge profits—and thus the funds for the subsidy—will be eroded.

Decreased revenue from this subsidy will force the local companies to charge higher access fees, encouraging long-distance companies and other corporations to devise new technologies that will bypass the local networks altogether. The costs of using antiquated technology will inevitably be borne by consumers who ultimately must either pay up or hang up.

Robert S. Smith
Terry S. Wiginton

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GDP IN 1982		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes			exchange rate in U.S. dollars April 20, 1983	change from year earlier	current monetary conditions		
												latest data	consumer prices	latest data					money supply(M1)
Argentina	Rising grain exports and import-substitution industries spurring economic recovery.	Dec.	-18%	130.0	4,594	Dec.	2,506	- 23%	6.2	895	Private debt being rescheduled.	Feb.	+245%	Nov.	+ 242%	.000029	- 65%	Central-bank credit restricted by IMF agreement.	Argentina
Brazil	Reported unemployment in key cities rises to 7.5% as industrial production and construction slow.	Dec.	-18%	293.0	2,382	Sept.	4,185	- 23%	2.4	544	Trade surplus improved in March.	Jan.	+105%	Nov.	+ 70%	.0022	- 68%	Credit ceilings unchanged since early 1983.	Brazil
Chile	Measures introduced to provide relief on local and foreign debt.	Feb.	+ 1%	23.7	2,060	Feb.	1,544	- 48%	5.8	458	Reserves fell an additional \$144 million in first half of March.	March	+ 25%	Dec.	- 8%	.0131	- 51%	Liquidity continues to contract.	Chile
Colombia	Government gives financial aid and rescheduling help to ailing textile and steel industries.	Oct.	+ 9%	39.0	1,423	Feb.	3,528	- 23%	7.6	0	Exchange rate under pressure from neighboring-country devaluations.	March	+ 22%	Nov.	+ 20%	.0150	- 29%	Bank reserve requirements cut to help liquidity.	Colombia
Costa Rica	All imports subjected to 40% duty in effort to boost government revenues.	Dec.	-15%	2.8	1,164	Feb.	291	+105%	3.9	109	Beef exports expected to be some 20% below last year's level.	Dec.	+ 82%	Nov.	+ 65%	.0250	-10%	Liquidity is tight.	Costa Rica
Ecuador	Exchange rate devalued and public spending cut to help balance of payments.	Nov.	-20%	14.0	1,573	Feb.	262	- 58%	1.6	0	Private-debt refinancing planned.	Dec.	+ 23%	Sept.	+ 25%	.0140	-42%	Credit restricted by central bank.	Ecuador
Guatemala	Government announces 10% budget cut in anticipation of IMF loan.	Dec.	+17%	8.4	1,090	Feb.	68	- 18%	0.6	104	Storm damages cause loss of about \$60 million in banana export earnings.	Dec.	- 2%	Nov.	+ 5%	Par	-	Monetary stance is restrictive.	Guatemala
Guyana	Negotiations being resumed with IMF after previous program lapses.	Dec.	-24%	0.4	490	Feb.	6	+140%	0.3	84	Loan payments in arrears.	Sept.	+ 19%	Jan.	+ 28%	.3921	+18%	Domestic credit is scarce.	Guyana
Honduras	Major Honduran conglomerate, Grupo Continental, expected to increase investment.	Oct.	-22%	2.8	718	Feb.	129	+ 26%	2.4	103	World Bank to increase funding to \$100 mn. from \$30 mn. in 1982.	Oct.	+ 11%	Oct.	- 13%	.5000	0	Limit of \$60 mn. set on banks' foreign-currency deposits.	Honduras
Jamaica	Expected loss of about \$200 million in bauxite earnings exerts pressures for tighter fiscal policy.	Dec.	-27%	3.1	1,378	Jan.	90	- 26%	0.7	612	Agreement reached to sell 1 million tons of bauxite annually to USSR.	Dec.	+ 7%	Dec.	+ 46%	5600	- 2%	Credit policy remains tight.	Jamaica
Mexico	Government to provide subsidized dollars for repayment of private-sector foreign debt.	Dec.	+ 8%	207.0	2,248	July	1,629	- 44%	1.3	328	First-quarter oil export earnings expected to be lower than official projections.	Dec.	+ 99%	Sept.	+ 58%	.0065	-70%	Credit growth being restricted.	Mexico
Nicaragua	Over \$200 million in new loans obtained from official lending institutions.	Dec. '81	+11%	2.7	930	June	110*	+ 13%	1.5	19	Venezuelan oil-import aid suspended.	Dec.	+ 30%	June	+ 32%	.0993	0	Net foreign assets at low level.	Nicaragua
Panama	Government austerity being implemented in effort to reduce foreign borrowing requirements.	Dec.	+64%	4.0	2,020	Dec.	101	- 16%	0.8	82	Rise in Canal income helps balance of payments.	Jan.	+ 3%	Dec.	+ 5%	Par	-	Domestic credit rises in real terms.	Panama
Paraguay	Currency devaluations and economic problems in Brazil and Argentina adversely affect business.	Nov.	+ 7%	5.7	1,691	Feb.	657	- 14%	12.1	0	Reserves drop as capital inflows decline.	Dec.	+ 4%	Aug.	- 4%	.00794	0	Credit is very restrictive.	Paraguay
Peru	Fiscal policy turns more restrictive; inflation at 85% annual rate.	Dec.	+ 1%	19.8	1,053	Jan.	1,156	0	4.1	628	Oil income will be down sharply owing to production problems, lower prices.	Feb.	+ 85%	Dec.	+ 35%	.00094	-44%	Credit policy is tight.	Peru
Puerto Rico	Economy beginning to recover from deep recession, paced by electronics, pharmaceuticals industries.	Dec.	+ 6%	12.6	3,875	Jan.	11,800**	- 1%	19.7	0	Foreign trade in surplus.	Jan.	+ 1%	Jan.	+ 1%	Par	-	Bank deposits increase.	Puerto Rico
Uruguay	Wide-ranging tariff-reduction program implemented to help offset burden caused by sharp devaluation.	Nov.	-12%	9.4	3,240	Dec.	116	- 73%	1.5	82	Principal payments on short-term debt suspended for 90 days.	March	+ 43%	Aug.	- 12%	.0295	-67%	Credit growth being constrained.	Uruguay
Venezuela	Government spending reduced by 7.5% as part of stabilization program.	Nov.	- 8%	73.0	4,966	Feb.	5,355	- 27%	5.2	0	Private debt receives preferential exchange rate.	Dec.	+ 8%	Nov.	+ 19%	.1081	-54%	Credit program is restrictive.	Venezuela

*Foreign assets **Commercial bank deposits

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World Interest Rates

market rates as of April 20, 1983; bond yields as of April 15, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.49	10.063 intervention rate	10.00	9.50	4.00	17.00 penalty rate 20.00	3.50	4.00	5.50
Day-to-Day Money	8.625 April 21	10.00	10.125	9.50	12.75	4.85	18.00	6.00	3.50 1-month Euro-Swiss fr. rate	6.188
Treasury Bills 91-day, Middle Rates	8.07	9.20	9.844	10.75	n. a.	n. a.	16.003 71 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.875 finance paper discount basis	9.30 finance paper 15% tax w/h	10.062	9.90 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	9.25 15% tax w/h	9.844	9.90 Certified	not traded	5.00	19.30	no market	4.188	no market
Government Bonds Long-term, new and old issues, average yield	10.51	11.27	10.19	10.52	13.77	7.55	18.14	8.04	4.44	7.131
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	11.91	12.02	14.74	14.90	7.60	17.76	8.29	5.71	6.47
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.50	14.55	8.00	19.50 1/4 qtrly fee on outstg.	6.00	7.50	6.00
Bank Time Deposits 3-month	8.45 Cert. of Dep.	9.25	10.25	10.50	12.375	4.90	11.50	5.625 large deposits	3.25 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.375	9.625	10.313	nr market	14.625	5.063	no market	5.50	4.375	6.313
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8085	1.563	.0204	.1356	.4068	.00068	.3617	.4840	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.198 D	1.024 D	1.430 D	4.425 D	4.326 P	7.018 D	3.871 P	5.124 P	2.947 P

Eurodollar Deposits

(London, interbank, bid)
April 21

7-day	8.938
1-month	9.00
3-month	9.125
6-month	9.25

International Arbitrage

(3-month, hedged)

→ in favor of U.S. dollars

U.S.-U.K. Treasury Bills	—0.615
U.S.-Canada Treasury Bills	—0.602
U.S.-Canada Finance Co. Paper	—0.100
Eurodollars-U.K. Local Auth. Deposits	+0.274

Eurobonds

(average yield on recent straight debt issues)

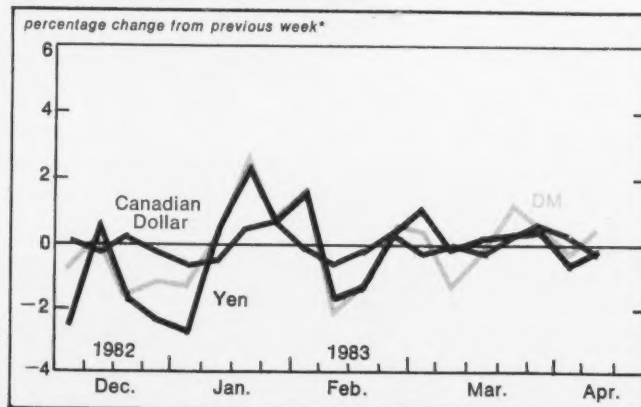
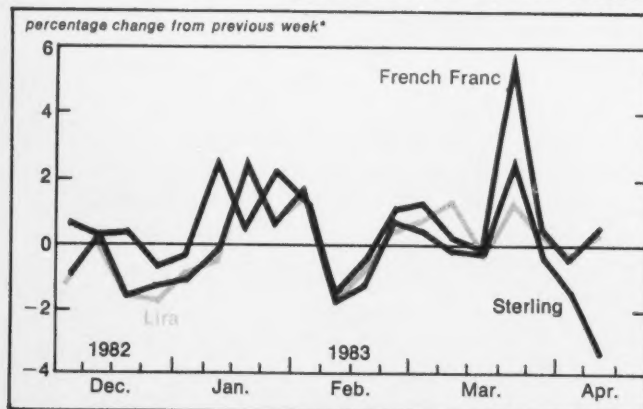
U.S. Dollar Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.75
DM Bonds	
7 yrs. and under	7.25
Over 7 yrs.	7.50

Gold Price

London afternoon fixing	
433.75	
(per fine ounce)	

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of the dollar against major currencies



*weekly average of daily figures, foreign currency units per U.S. dollar

Monetary Policy: The Bulge That Binds

The persistent rapid money growth of the last six months is threatening to unravel the Federal Reserve's inflation-fighting credibility earned during the 1979-82 era of strict aggregates targeting. Repeated disclaimers by Fed officials—assertions that the money bulge is merely the result of technical distortions caused by the introduction of new bank accounts—appear to be wearing thin. And the recent backup in interest rates is, in part, indicative of growing market fears that monetary policymakers may be reverting back to the expansionary tactics of the 1970s. Unless the monetary buildup is soon reversed or unless a more plausible explanation can be found, market skepticism could force the Fed to tighten actively as a demonstration of its resolve not to pursue inflationary policies. This would temporarily drive up short-term rates and possibly choke off the still-fragile economic recovery.

The unfortunate aspect of the whole matter is that market concern may be misplaced. It is highly probable Fed officials are actually telling the truth when they insist they are not pursuing an inflationary monetary policy. Much of the acceleration in money growth may be the result of demand forces that the Fed is simply accommodating. There are a number of reasons businesses and individuals may just want to hold higher levels of money balances—without immediately spending them. If this is true, then the stepped-up monetary expansion carries no serious inflationary implications and there is, in fact, no need for the Fed to tighten.

A number of reasons have been put forth as to why the public's preference for cash balances may have risen:

- The creation of interest-bearing checking accounts, such as the "Super-NOW accounts—the Fed's own rationale for the money bulge—has reduced the cost of holding transaction balances, encouraging businesses and consumers to keep larger amounts of readily available funds on hand.
- Greater uncertainty over interest rates, price movements, employment, and the overall health of the economy has increased the desire to maintain greater precautionary money balances.
- As a result of increased efforts to hide transactions and wealth from the government, the so-called "underground economy" has mushroomed, stepping up the demand for currency, and possibly expanding demand deposits as well.
- The tax cut and other new incentives for savings implemented by the Reagan administration have enhanced the relative attractiveness of financial assets compared with real assets or consumption—including those relatively liquid financial assets measured as part of M1 and M2.

In addition to these principally domestic influences, however, there are international sources of change—largely overlooked—that may offer clues as to whether the surge in U.S. money growth is actually the result of a benign upward shift in money demand. These stem from the sizable inflow of foreign capital into the United States during the past year.

Altered preferences

Because of more-pronounced uncertainties abroad and the renewed and sustained strength of the dollar in the foreign-exchange markets, foreigners have apparently developed a greater preference for dollar assets. For 1982 as a whole, foreign assets in the United States rose by some \$87.3 billion, an increase 41% greater than the 1981 inflow. Conceivably, a good portion of the rise in the U.S. money supply could have come from this change in currency preference.

Although the reported growth of foreign deposits in the United States was substantial—\$33.5 billion in 1982 and \$13.9 billion in 1981, according to the international-capital data of the U.S. Treasury—only a small portion was captured in the U.S. monetary aggregates. The deposits of foreign governments and banks, as well as International Banking Facility deposits, are excluded from U.S. money-supply figures. And no more than \$2-3 billion of the \$42-billion increase in M2 in the fourth quarter of last year can be traced directly to the growth of deposits by foreigners. The overall impact, however, was undoubtedly much greater. Once indirect and unreported flow effects are taken into account, the impact of the change in preference for dollar assets on the U.S. monetary aggregates appears to have been quite substantial.

The reported data captured only a fraction of the actual increase in foreign financial assets coming into the United States. Closer examination of the data shows that a large percentage of the foreign capital inflows came from Latin American countries. Because of existing political and economic tensions, many Latin American residents may have had strong incentives to disguise ownership of their financial assets from the U.S. government. Given the proximity of these countries to the United States and the close personal ties many Latin American residents have with U.S. residents, substantial funds easily could have entered the country unreported and could have been maintained in accounts not identified as foreign. In many cases, these funds would be counted in Federal Reserve money-supply figures but would not show up as foreign assets in the Treasury reports.

The so-called "statistical-discrepancy" line of the U.S. balance-of-payments statistics—which captures what is unreported as well as errors—supports the

Monetary Policy: The Bulge That Binds *(continued from page 7)*

conjecture that the second half of last year saw a marked shift into dollar assets. Third-quarter 1982 figures (the latest period for which data are available) show a \$12.4-billion unexplained flow of funds into the United States from Latin America. This is a striking difference from the \$2.4 billion outflow and \$1.4 billion inflow of the first and second quarters, respectively.

There are other indirect ways a shift in currency preferences may have affected the growth of the U.S. monetary aggregates. For example, net foreign purchases of U.S. securities rose some \$24.2 billion in 1982. If a foreigner bought dollar securities from a U.S. resident, foreign deposits would be transferred to the checking account of the domestic seller, increasing the level of demand deposits in the United States and thus, the money supply—at least temporarily. A similar effect would result if foreign companies—because of such influences as relatively high U.S. interest rates or adverse exchange-rate movements—decided to reduce the level of outstanding credit extended to them by U.S. exporters. The most recent U.S. statistics show that net non-bank claims on foreigners fell some \$5.2 billion in the first nine months of 1982.

One of the most important generators of currency-substitution effects on the U.S. money supply might have been the portfolio-management activities of U.S. multinational corporations. These firms, whose financial assets are located in many countries and denominated in a variety of currencies, may also have found dollar balances to be preferable to balances in other currencies. If so, they may have run down their balances abroad in making payments while building up balances at home. Such moves would have contributed to an increase in money demand in the United States that would not be easily identified from the collected statistics of the monetary authorities.

Policy dilemma

Many of these potential sources of a shift in currency preference in favor of the dollar are difficult or even impossible to verify. Nevertheless, like the domestic influences mentioned earlier, they do raise serious questions about possible shifts in the demand for money in the United States. It seems quite probable that there has been a significant increase in U.S. money demand. This would go a long way toward explaining why the United States has continued to experience the odd combination of sluggish growth, still-declining inflation, and a strong dollar, despite persistently robust growth in the supply of money.

The verification of a change in money demand has important policy implications. In 1937, the Federal

Reserve—seeing the banking system with a high level of excess reserves and fearing the inflationary potential of such a situation—raised reserve requirements. In doing so, it helped to abort the recovery from the Great Depression. Fed officials at the time failed to take account of the fact that the banks had built up reserves not out of a desire to lend, but as a precaution against further runs on the banks. That is, the monetary authorities were unaware that a change in the preference for excess reserves had occurred. Some 46 years later, the Federal Reserve may be making a similar mistake. By concentrating on a narrow view of aggregates targeting, monetary policymakers may adopt a stance that is unnecessarily tight.

The Federal Reserve now, however, also faces an additional constraint. Even if it becomes necessary to abandon strict aggregates targeting, it is not clear the authorities can afford to do so. A bad reputation is hard to live down. As a result of policy inconsistencies during the late 1960s and much of the 1970s, the monetary authorities suffered a tremendous loss of credibility. In fact, it was only through their strict adherence to pre-set target levels of money growth from October 1979 through mid-1982 that the market was finally convinced Fed policymakers were serious about bringing inflation under control. To abandon aggregates targeting now would endanger this hard-won credibility. Because of past experience, the only way the markets can be certain the monetary authorities are not engaging in inflationary policies is by the Federal Reserve's adherence to its self-imposed aggregates targets.

Thus, owing in large part to its own credibility gap, the Fed is now confronted with a crucial policy dilemma: If it tightens but money growth proves to have been largely demand-determined, the U.S. recovery will be snuffed out and the world economy put under renewed strain. On the other hand, if it does nothing and the money bulge turns out to be primarily the result of supply forces, the Fed will lose its credibility completely and the world will be exposed to a new boom-bust cycle. In short, the Fed finds itself tied to a policy that may be too confining, given the confusion over the source of the recent rapid money-supply growth.

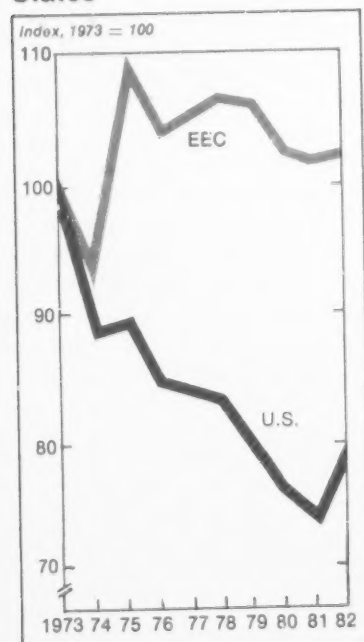
Paradoxically, what the Fed needs to free up its operating strategy for possible expansive actions may be some sort of institutional change that would limit its ability to engage in inflationary policies—perhaps a legal obligation to maintain a fixed exchange rate or gold cover. Such a limit, however, would at the same time have to be devised in a way that would allow the Fed enough flexibility to respond to temporary and cyclical changes in money demand.

Vincent Salvo

High Wages Dampen European Growth Prospects

High labor costs continue to cloud the medium-term growth prospects for Western Europe. Wages have risen more rapidly than prices in the manufacturing sector in Europe over the past 10 years, although there has been a tendency for the pace to slacken since 1979. In the United States, in contrast, manufacturing wages have risen somewhat more slowly than prices since 1973. This differential in the rate of change of real-wage costs is only partly consistent with differences in the rate of growth of labor productivity. While the increase in manufacturing labor productivity has been higher in Europe than in the United States, increases in productivity in Europe lagged behind advances in real wages during much of the 1970s. As a result, unit-labor costs in manufacturing—the labor cost of producing a given volume of output—although falling in recent years, still stand higher in real terms in most of the European economies than before the first OPEC price shock. The reverse is true for Germany and the United Kingdom, but even in those economies the post-1973 decline in real unit-labor costs still falls short of that of the United States.

The real cost of labor* in Europe and the United States



*unit labor cost in manufacturing adjusted for changes in industrial wholesale prices

Underlying this superior post-1973 U.S. performance in real unit-labor costs are major differences in labor market characteristics between the United States and Europe. In much of Europe there is a significant political influence over wage levels exercised through such devices as mandatory wage-indexing formulas, minimum-wage legislation, and pace-setting wage negotiations between the government and public-sector employees. In the United States, the influence of government policy over wage levels is far less. In addition, U.S. labor contracts are of a longer average duration than in Europe, resulting in a tendency for wages to lag behind prices in periods of accelerating inflation.

The steady upward drift of unemployment rates in Europe has forced a somewhat belated recognition of the problems created by excessive real-wage growth. In a number of countries where real unit-labor costs are particularly high relative to 1973 levels—Belgium, the Netherlands, Denmark, France, and Italy, for example—steps to achieve greater real-wage flexibility have been taken over the past year, mainly in the form of loosened or temporarily suspended wage-indexation formulas. These moves have been helpful, but unless further cuts in real wages are accepted or payroll taxes are reduced, excessive real labor costs will continue to act as a brake on potential growth in most of the European economies.

Spain's economic policies turn restrictive.

After a long delay, Spain's 1983 budget has finally been presented to the Cortes. The document confirms that the new Spanish government is determined to place the financial and monetary sectors on a sound footing before directly addressing the growing unemployment problem. The budget projects an overall deficit of 1,100 billion pesetas—roughly equivalent to 5% of GDP and significantly lower than the 1,350-billion-peseta deficit initially indicated in the government's economic program. This involves an increase in income taxes and a reduction in the social security budget but an expansion in public-sector investment. Meanwhile, the authorities are effecting a restrictive monetary policy in order to reduce inflation from the 14% annual rate of 1982 to a targeted 12% in 1983. Required reserve deposits at the Bank of Spain have recently been raised to 4% of total deposits from 3% in an attempt to trim money-supply (M3) growth from a year-on-year rise of 16.3% in January to 13%. As a result, interest rates have come under upward pressure, with interbank rates now over 20%.

New Austrian government unlikely to change course.

The Austrian economy performed quite well last year in comparison with other European economies. Real output expanded by about 1% while inflation was held to 5.4%, and the current account swung to an 8-billion-schilling surplus. However, unemployment rose to 4.5% at the end of last year, almost double the year-earlier rate, and the public-sector deficit has grown rapidly. At this stage, Vice-chancellor Sinowitz is trying to form a coalition government, probably with the small centrist Freedom Party that now holds the balance of power. This follows the recent resignation of Socialist Chancellor Kreisky, who suffered an electoral setback. Whatever the outcome, Austrian economic policy is unlikely to undergo a radical transformation. There is a reasonably high degree of consensus among the political parties, and Austria is a small, open economy highly dependent on developments in the rest of Europe, especially in Germany. The economic outlook, therefore, is for a further decline in inflation, a modest pickup in economic growth, and a continuation of a slight current-account surplus.

Icelandic election fails to produce mandate for corrective economic policies.

Many Icelanders had hoped that the general election of April 23 would bring in a government with a clear mandate to enact tough policies to rectify its many economic problems: Inflation has remained near 50% and is in danger of reaccelerating. In addition, the critical fish catch is down sharply and the market for fish exports appears to be shrinking. Finally, Iceland's aluminum and ferrosilicon exports have been hard hit by the continuing global recession. GDP is expected to decline by about 3% this year after a 3.5% fall in 1982, while the current-account deficit will remain close to 11% of GDP. The election, however, failed to produce a clear winner. The ruling left-center coalition has officially resigned, but forming a new government will take time. Unless new elections are called that then produce a more decisive result, no new government is likely to have sufficient coherence to introduce the urgently needed corrective policies. Iceland's economy thus seems destined to remain in trouble for at least another year. And even then, any improvement will be heavily dependent on the strength of world recovery.

Chilean monetary authorities act to offset effects of reserve drain.

In the first quarter of 1983, Chile lost nearly \$1 billion in net international reserves. Approximately 60% of the reserve loss was due to repayment of short-term debt. The rest of the drain could be traced principally to the financing of the current-account deficit and obligations excluded from the present freeze on foreign debt repayment. This loss in reserves could have caused a severe contraction in the monetary base, and thus, the money supply. The Chilean authorities, however, fully offset the potential reduction in the base by increasing domestic credit. Net domestic assets expanded from a negative 24.5 billion pesos in December to 51.2 billion pesos at the end of March. These developments, however, placed Chile in noncompliance with the IMF ceilings on net international reserves and net domestic assets for March. Nonetheless, by restricting domestic credit growth and by obtaining new funds from international commercial banks, the Chilean authorities intend to get back on track with the IMF program by September.

*Costa Rica's
balance-of-payments
outlook improves.*

Costa Rica's balance-of-payments problems are showing encouraging signs of receding. Recent reports are that the long debt-restructuring negotiations have been finalized and that the government and the commercial banks are expecting to sign a new agreement by May 30. The proposed agreement calls for the setting up of a revolving trade facility and a debt restructuring that includes past-due principal and payments due in 1983 and 1984. There also has been some unexpected good news on the trade balance. The fall in crude-oil prices has led to a reduction in the country's petroleum import bill, and the price of bananas—Costa Rica's main export—rose by 40% in the last quarter because of crop failures elsewhere. Finally the government's political detachment from Nicaragua's Marxists has bolstered domestic business confidence and improved Costa Rica's chances of receiving additional economic aid from the United States. The country's debt ratio will still exceed 50% in the years after 1985, but recent favorable developments should help Costa Rica ride out these difficult times.

*Oil price drop
spurs devaluation,
could prompt development
cutbacks in Indonesia.*

On March 30, the Indonesian rupiah was devalued by 27.4% from 704 per U.S. dollar to 970. The move, which had been widely anticipated, became inevitable with the reduction in OPEC crude-oil prices earlier in the month. In the fiscal year just-ended March 31, the current-account deficit climbed to over \$7 billion. And the oil-price cut threatened to widen the gap still further. Foreign-exchange reserves—including those held by state banks—dropped by about \$4 billion to slightly above \$6 billion. The new exchange rate reportedly was calculated as one that would return the competitiveness of Indonesian goods back to the level of November 1978—immediately following the last major devaluation. However, it is unlikely that the devaluation itself will be enough to remedy the balance-of-payments deficit, and cutbacks in some capital-development projects are possible. Although these measures would be painful, coming after sharp cuts in subsidies for fuel and food, the government nonetheless seems resolved to preserve Indonesia's creditworthiness and reputation for sound economic management.

*New Zealand inflation-
fighting tactics
showing results at last.*

The drastic measures instituted last year by the New Zealand government to bring rampant inflation under control finally appear to be taking hold. The persistence of double digit inflation—at a time when inflation rates in most of the other OECD countries were slowing markedly—was eroding New Zealand trade competitiveness and keeping the New Zealand dollar under severe downward pressure. Following a 15.3% rise in consumer prices in 1981, inflation hit an annualized rate of 21.6% in the second quarter of 1982. In an effort to reduce this dangerous trend, Prime Minister Muldoon tightened monetary policy dramatically and on June 22 enacted a one-year wage-price freeze. The nation's money supply fell in both the second and third quarters of 1982, and rose during the fourth quarter at an annual rate of only 3.6%. Nonetheless, New Zealand inflation remained stubbornly high relative to the rest of the OECD—15.2% and 11.1% in the third and fourth quarters, respectively. More recent statistics have been much more encouraging: Inflation in the first quarter of this year came in at an annual rate of 3.2%—far better than even the optimists could have hoped for.

*Jordan moves to
offset its reduced
Arab funds transfers.*

Although not an oil producer itself, Jordan has inevitably been hurt by the impact of the weak oil market on its Arab neighbors. Unofficial estimates show workers' remittances rising by only 12% in 1982 to \$1.08 billion, down from 44% in 1981. Moreover, aid receipts, mainly from Arab states, appear to have declined by as much as 20% to \$990 million. Partly as a result, the current-account deficit probably widened sharply to about \$200 million from \$42 million. The authorities, however, have responded positively. In the 1983 budget, the increase in overall spending was reduced to only 4%—with capital spending down by 12%. And the Jordanian economy remains in a strong position. Foreign-exchange reserves totaled \$826 million in February, not counting about \$450 million in gold. This provides a very comfortable coverage, equivalent to four-and-a-half months of imports.

Can the Bull Market Last?

The U.S. stock-market rally—already longer than most analysts had expected—is continuing. Despite some pauses in its upward climb, the Dow-Jones industrial index has soared 56% since last August—much faster than most of the stock-index advances in other major industrial countries. But while there are some strong fundamental reasons to expect the near-term trend to continue upward, the longer-term outlook is far more uncertain.

The most important boost to the stock market has come from the emergence of clear signs of economic recovery. For example, in the last four months U.S. industrial production has risen 3% and labor productivity has increased at an annual rate of 4.8%. As a result, first-quarter corporate operating profits are expected to have risen nearly 25% from their levels of a year ago.

The other major fundamental force behind the runup in stock prices is the favorable outlook for inflation—for the next year or so at least. During the 1970s, stock prices languished as accelerating inflation eroded real corporate profits. But with the Consumer Price Index expected to rise less than 4% this year, most of the gains in corporate profitability will be real.

There are, however, some indications that the stock market's performance may have been more exuberant than these fundamentals warrant. While stock prices typically rise before a recession's end, the magnitude

of this rally is about twice as large as the rallies that began near the end of the 1969-1970 and 1973-1975 recessions—even though both earlier recoveries got off to a much faster start.

One possible explanation for the extraordinary strength of the current market may be the expectation of a longer-lasting slowdown in inflation. The improvements in inflation during and after the two recessions mentioned above were not nearly as dramatic as in the recent experience. Moreover, those earlier slowdowns in inflation rates proved to be only temporary.

A reemergence of rising inflation expectations would almost certainly preclude a prolonged stock market rally. And while the immediate outlook for inflation is quite favorable, there are some less-optimistic portents that bear watching. The rapid increase in the money supply since last August is one sign that faster inflation may lie ahead in the future. More immediately troubling is the rapid rise of certain commodity prices since last fall; in past recoveries, these prices did not start rising until a year or so into the recovery. A key clue for stock market followers trying to anticipate the end of the current rally would be the emergence of more-general price pressures. Such a development, combined with any signs that the recovery is even weaker than is now expected, could easily put an end to the great bull market of 1982-1983.

Douglas L. Bendi

The Rise and Fall of the Money Funds

The last decade has been marked by a number of financial-market innovations. The most prominent of these has been the creation of money-market mutual funds (MMMFs). In the past few years, this vehicle has become a significant source of investment funds and a catalyst for the transformation of the U.S. financial system. But now, as a new era of bank deregulation begins, the funds seem to have lost their luster. As each week passes, redemptions exceed sales and net asset levels fall.

The rise of this financial asset form resulted from the strict retention of Regulation Q by the Federal Reserve in a period of high and rising interest rates. By artificially restraining what a bank could pay on its deposits, an incentive was created for disintermediation or some form of arbitrage. By lending directly to borrowers or investing in bank deposit instruments exempt from ceilings investors could gain market rates of return. Into this opening, the MMMFs stepped. They provided a vehicle for the pooling of funds to purchase high-yielding money-market instruments.

Since December 14, when banks were first allowed to offer accounts yielding competitive rates of return, MMMFs have come under intense competitive pressure and assets have fallen sharply. Banks have been offering accounts that well match the returns or services available from MMMFs and that have the added attraction of federal deposit insurance.

In a regulated environment, it was the MMMFs that

had the advantage. Now the situation is reversed. It is impossible for the funds to offer more-generous returns than the banks when their portfolio consists largely of government securities and bank instruments (certificates of deposit, bankers acceptances, and repurchase agreements, for example). The former do not earn enough, and the latter will not deviate from what banks would pay on individual deposit accounts.

To compete, the MMMFs must become more like banks. They will have to lend directly to industrial and commercial borrowers in order to earn returns capable of supporting competitive rates on investor balances. To further approximate the attraction of bank accounts, they must secure private insurance to reduce risks to investors.

But in achieving parity, another problem emerges. MMMFs are not designed for the task of allocating capital to final industrial and commercial users. The proper structure and incentives for credit-risk evaluation and management do not exist. To expand their scope of operations, MMMFs will have to change. As with banking institutions, credit-analysis capabilities must become an integral part of their operations.

In sum, the MMMF is a byproduct of a regulated market. With regulations being dismantled, the basis for their existence has disappeared. To compete in the marketplace, the funds will have to alter their structure. Failure to do so will result in a diminishing role for them in the economy's capital-allocation process.

Vincent G. Salvo

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest date	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes		exchange rate in U.S. dollars May 4, 1983	change from year earlier	current monetary conditions			
												latest date	consumer prices				latest date	money supply(M1)	
Algeria	Homebuilding program for 1983 scaled down because of tighter budget situation.	Jan.	- 6%	36.0*	1,935	Feb.	2,296	-36%	1.0	0	Oil price cut by \$5.00 per barrel to \$30.50.	Dec. '80	+10%	Aug.	+22%	.2115	- 5%	Sonatrach to raise a \$500-million Eurocurrency loan.	Algeria
Cameroon	Douala port capacity to be increased substantially with \$22.5 million World Bank loan.	March	- 4%	7.8	890	May	28	-68%	0.3	0	Ad valorem export duty to be lifted in case of commodity price fall.	Sept.	+11%	Sept.	+19%	.0027	-18%	Credit restraint continues.	Cameroon
Egypt	Government to compensate for lower oil earnings by cutting expenditures and raising non-oil exports.	Nov.	+23%	30.8	710	Dec.	698	- 3%	0.8	56	Oil prices to be raised by 25¢-50¢ per barrel as of May 1.	Nov.	+14%	Dec.	+26%	1.2100	- 1%	World Bank loaned Egypt \$472 million last year.	Egypt
Gabon	Austerity measures are to be introduced following fall in oil revenues.	Dec.	- 5%	3.4	6,180	Sept.	309	+59%	30.5	10	Current-account surplus continues to shrink; overall deficit likely this year.	May	+20%	Sept.	+24%	.0027	-19%	Gross reserves decline.	Gabon
Ghana	State expands its role in trading, banking, and insurance; textile company nationalized.	Dec. '81	-34%	n.a.	n.a.	Dec.	142	- 4%	2.0	17	Surcharges will be imposed on imports and bonuses given for exports.	Oct.	+12%	Dec.	+19%	.3636	0	Growth of money supply decelerates.	Ghana
Ivory Coast	New 1981-85 Five-Year Plan assigns highest priority to modernization of agricultural sector.	Nov.	-28%	9.8	1,190	Dec.	2	-88%	0	516	Lower export receipts owing to bush fires in cocoa, coffee, and timber areas.	Dec.	+ 6%	Aug.	+11%	.0027	-18%	Debt service expected to claim 40% of exports in 1983.	Ivory Coast
Mauritius	Austerity policy continues; 1982 real growth estimated at 6%.	Dec.	+34%	1.0	1,016	Feb.	39	+38%	1.0	167	Trade deficit halved in 1982 to \$76 million, as export receipts rose 30%.	June	+12%	Jan.	+ 8%	.0902	- 4%	External debt service rising steeply.	Mauritius
Morocco	World Bank to lend \$127 million for irrigation projects and road building.	Oct.	-15%	15.2	735	Jan.	77	-14%	0.2	942	Govt. reduces number of goods that can be imported without restrictions.	Nov.	+ 7%	Sept.	+18%	.1513	-19%	Japan to lend \$80.4 million for phosphates project.	Morocco
Nigeria	Motor-assembly industry takes brunt of economic downturn, suffers wage-cuts and lay-offs.	Jan.	- 9%	86.8	1,125	Jan.	1,295	-51%	0.7	0	Oil output in April remains under 1 mbd —below 1.3 mbd OPEC target.	Sept.	+ 4%	Sept.	+ 5%	1.4450	- 3%	Acute foreign-exchange shortage continues.	Nigeria
South Africa	Led by agriculture, 1982 real GDP declined 1%; upturn awaits export pickup.	Dec.	- 6%	77.5	2,573	Feb.	1,129	+31%	0.8	867	Imports of 1.5 mn. tons of corn foreseen this year, owing to drought.	Jan.	+15%	Dec.	+16%	.9195	- 3%	Inflation rate ebbs slightly.	South Africa
Tanzania	Industry running at 15%-30% of capacity as country experiences severe economic crisis.	June	-31%	6.2	338	Nov.	7	-71%	0.1	80	Lack of imported inputs, retards export performance.	March	+34%	Nov.	+14%	.1036	- 2%	IMF proposes substantial shilling devaluation.	Tanzania
Tunisia	Manufacturing output officially projected to rise by 12% this year compared with 3.4% in 1982.	Sept.	-15%	8.1	1,240	Feb.	511	-11%	2.0	0	Oil output averaged 100,000 b/d last year, down from 110,000 b/d in 1981.	Dec.	+14%	Nov.	+24%	1.5200	-14%	Claims on private sector rising steadily.	Tunisia
Zimbabwe	Real output likely to fall by at least 3% this year after 2% growth in 1982.	Aug.	-11%	6.7	870	Nov.	137	- 5%	1.1	0	Sharp increase in foreign debt to an est. \$1.5 billion at end-1982.	Oct.	+18%	Aug.	+12%	1.0400	-23%	Inflation accelerating.	Zimbabwe
Kuwait	Budget for fiscal 1983/84 projects spending increase of nearly 4% to \$12.1 billion.	Jan.	+ 8%	24.3	17,350	Feb.	5,631**	+51%	8.5	0	Official oil price cut to \$27.30 per barrel, down \$4.00 from January.	Sept.	+ 8%	Dec.	- 3%	3.4200	+37%	Syndicated lending in Kuwait picking up.	Kuwait
Oman	Budget for 1983 forecasts deficit of \$600 million; actual gap will be smaller because of underspending.	Oct.	- 5%	4.8	5,380*	Jan.	1,296**	+22%	9.4	0	Oil output avgd. 362,000 b/d in Jan.-Feb., 11% above same 1982 period.	n. a.	n. a.	Oct.	+16%	2.8970	0	Government borrowed \$81.3 million for power station.	Oman
Qatar	Budget for fiscal 1983/84 projects expenditures of \$1.1 billion compared with \$1.6 billion last year.	Jan.	-16%	6.0	24,000	Sept.	388**	+12%	2.3	0	Oil prices cut by \$5.00 per barrel as of March 1.	n. a.	n. a.	Sept.	+18%	.2747	0	Growth of money supply slowing.	Qatar
Saudi Arabia	Budget for fiscal 1983/84 projects expenditure of \$75.7 billion, 7.2% over actual spending last year.	Jan.	-42%	155.8	16,719	Feb.	27,938**	-16%	9.7	0	Oil output averaged 4.2 mbd in Jan.-Feb., 51% below same 1982 period.	Sept.	- 1%	Sept.	+19%	.2900	- 1%	Royal decree designates only banks as stock brokers.	Saudi Arabia
United Arab Emirates	Abu Dhabi to eliminate new projects worth \$1 billion to trim 1983 budget deficit.	Jan.	-18%	29.8	29,780	Oct.	3,111	- 2%	4.3	0	Abu Dhabi oil output avgd. 700,000 b/d in Jan.-Feb.	n. a.	n. a.	Nov.	+ 6%	.2730	0	Abu Dhabi backdates 20% tax on foreign-banks to 1982.	United Arab Emirates

*1980

**Excluding state reserves

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World Interest Rates

market rates as of May 4, 1983; bond yields as of April 29, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.37	10.063 intervention rate	10.00	9.50	4.00	17.00 penalty rate 20.00	3.50	4.00	5.50
Day-to-Day Money	8.625 May 5	10.75	10.375	9.60	12.625	5.00	18.00	6.25	3.875 1-month Euro-Swiss fr. rate	6.188
Treasury Bills 91-day, Middle Rates	7.99	9.15	9.75	10.35	n. a.	n. a.	16.498 85 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.30 finance paper 15% tax w/h	9.30	9.90 Certified	12.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.20	9.17 15% tax w/h	9.688	9.90 Certified	not traded	5.65	18.95	no market	4.688	no market
Government Bonds Long-term, new and old issues, average yield	10.48	11.20	10.34	10.31	13.71	7.63	18.01	8.33	4.40	7.08
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	12.25	12.14	12.28	14.84	7.70	17.74	8.57	5.53	6.49
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.50	14.55	9.00	19.50 1/4 ctry fee on outstg.	6.50	7.50	6.00
Bank Time Deposits 3-month	8.25 Cert. of Dep.	9.40	10.063	10.10	12.50	5.25	11.50	6.125 large deposits	3.50 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	8.938	9.313	10.188	no market	16.00	5.063	no market	5.563	4.563	6.313
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8161	1.583	.0205	.1351	.4090	.0007	.3641	.4856	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.343 D	1.112 D	1.463 D	7.106 D	4.010 P	16.327 D	3.406 P	4.613 P	2.652 P
Eurodollar Deposits (London, interbank, bid) May 5	7-day 8.688 1-month 8.688 3-month 8.750 6-month 8.813	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills -0.514 U.S.-Canada Treasury Bills -0.490 U.S.-Canada Finance Co. Paper -0.330 Eurodollars-U.K. Local Auth. Deposits -0.013				Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 10.375 Over 7 yrs. 10.625 DM Bonds 7 yrs. and under 7.50 Over 7 yrs. 7.75			Gold Price London afternoon fixing 432.75 (per fine ounce)	

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Mar.) 3.6	(Mar.) 7.2	(Mar.) 4.6	(Mar.) 9.0	(Apr.) 3.3	(Apr.) 16.6	(Mar.) 4.8	(Mar.) 2.3
Industrial production*	(Mar.) -1.8	(Feb.) -3.3	(Feb.) 2.9	(Feb.) 0.8	(Feb.) -5.6	(Feb.) -9.2	(Dec.) -8.5	(Mar.) -2.0
Trade balance† (billions of local currency units)	(Mar.) -\$3.63	(Feb.) C\$1.44	(Mar.) £0.38	(Mar.) -FF6.58	(Mar.) DM5.50	(Jan.) -Lit.2,620	(Mar.) -SF1.02	(Mar.) ¥679
Money supply (M1)*	(Feb.) 9.5	(Feb.) 9.6	(Feb.) 10.8	(Feb.) 10.7	(Feb.) 9.8	(Nov.) 17.4	(Mar.) 5.8	(Feb.) 6.4
Velocity of money (M1)*	(Dec.) -4.64	(Dec.) 0.54	(Dec.) -1.88**	(Sept.) 0.58**	(Dec.) -3.66	(Sept.) 2.69**	(Mar. '82) 9.30**	(Dec.) 0.77
Reserves minus gold (\$ million, change from previous month)	(Mar.) 29	(Mar.) -363	(Mar.) -390	(Feb.) -2,364	(Mar.) 1,947	(Mar.) -676	(Mar.) 700	(Mar.) 259

* Percent change from 12 months earlier.

** based on GDP.

† Figures are only for the month indicated.

Foreign Constraints Hinder Japanese Recovery

Japan is expected to show only a modest pickup in economic growth this year from 1982. And because continuing tensions between Japan and its major trading partners are likely to limit any rebound of exports, the economy will once again be forced to draw its strength from domestic sources. Any attempts to boost activity at home via stimulative monetary policy will be hamstrung by concerns over the behavior of the yen. Because of this, the Japanese government appears to be on the verge of slightly relaxing its previously rigid stance against stimulative fiscal policies.

Last year brought Japan another year of relatively sluggish growth: On a calendar-year basis, real GNP rose 3%—down from a revised 3.8% in 1981 and much slower than the 5.1% average recorded during 1976-1980. The slowdown was touched off in 1981 by unusually weak domestic demand. It was prolonged, however, by a collapse of some of Japan's key export markets starting in the fourth quarter of that year, which, in turn, set off another round of inventory adjustment. Exports of goods remained extremely depressed in 1982—despite a weak yen—in part because of the recession in the rest of the world, but also because of increased protectionist pressures aimed at Japanese products. As a result, in sharp contrast to 1981 when growth was overwhelmingly export-led, net exports accounted for only about 7% of the rise in real GNP last year (see chart, next page). This left domestic demand as the principal source of growth.

Fortunately, private consumption spending was particularly strong in 1982, rising 4.2% in real terms and contributing almost three-fourths of the overall growth in economic activity. This surprising performance can be traced to a decline in the savings rate and to a marked slowdown in inflation, which boosted real disposable income. Residential housing investment remained depressed for much of last year, although an increase in government financing spurred a revival of housing starts during the second half. Private plant and equipment investment by large businesses continued firm, but investment by small enterprises—which accounts for some 60% of total investment—remained depressed.

Despite signs that much of this weakness is continuing, there are a number of reasons to expect activity to pick up over the next several months. The most important forces include:

- The steep drop in international oil prices, which will boost the profits of a number of key industries using petroleum products as inputs and help to moderate inflation;
- A somewhat stronger yen, which will also improve the profitability of domestic raw-material-importing firms;

- Accommodative monetary policy and a slightly more expansionary fiscal policy, marked by a promise of an income-tax cut during fiscal 1983, which just began April 1; and

- Recovery in the United States and Europe.

Historically high unemployment, along with a freeze on government employees' salaries and the depressed state of business activity, is expected to hold the wage increase resulting from spring labor negotiations to around 5%. Provided that monetary policy does not turn overly expansionary, the decline in world oil prices and the anticipated stronger yen should keep the average rise in this year's consumer prices at about 2.3%—even lower than 1982's 2.7%—although some reheating can be expected toward year-end. This continued low rate of inflation—together with an income-tax cut and improvements in overtime, bonus payments, and employment as businesses start to recover—can be expected to result in a sufficient increase in real disposable income to support close to a 4% advance in real private consumption spending.

Residential housing investment is projected to rebound modestly, and businesses' currently-weak capital spending plans are likely to be revised upwards as profitability improves and the outlook brightens. Japanese exports will pick up some as the U.S. and European economies recover. But any increase is likely to be quite modest owing to the growing trade restrictions that have arisen from the continued frictions between Japan and its major trading partners. As a result, net exports are projected to make only a minor contribution to growth in 1983, and for the second consecutive year the economy is expected to be led by domestic demand.

All in all, Japan can be expected to record modestly faster real growth in 1983—perhaps in the neighborhood of 3.2%.

External affairs

Japan's trade surplus shrank to \$18.2 billion in 1982 from close to \$20 billion in 1981. Despite a markedly weaker yen, export volume fell more than 3%, primarily because of sluggish overseas demand arising from the world recession, but also because of increased protectionist restrictions and "voluntary" restraints on Japanese exports. In value terms, exports dropped 7.9%, registering the first year-over-year decline since 1953. Imports also fell—some 7.8% in value terms—owing to a decline in the price of crude oil, sluggish world commodity markets, the depressed state of the domestic economy, and a 7% decline in the volume of imported oil and oil products. Despite the smaller trade surplus, the current-account surplus widened to \$6.9 billion from \$4.8 billion in 1981 as in-

Foreign Constraints Hinder Japanese Recovery *(continued from page 7)*

creased income from overseas investments led to a much smaller deficit on the services account.

As for the capital account, 1981's capital outflow of \$7.4 billion was more than doubled in 1982 for an all-time high net outflow of almost \$16 billion. The large net outflow resulted primarily from sharply lower foreign investment in Japan, increased direct investment by Japanese firms abroad, stepped-up foreign lending by Japanese banks, and expanded issuance of yen bonds by foreigners. Reflecting the excess supply of yen, the overall balance was in deficit to the tune of \$5 billion, and the exchange rate averaged 249 against the dollar, off 12.9% from 1981.

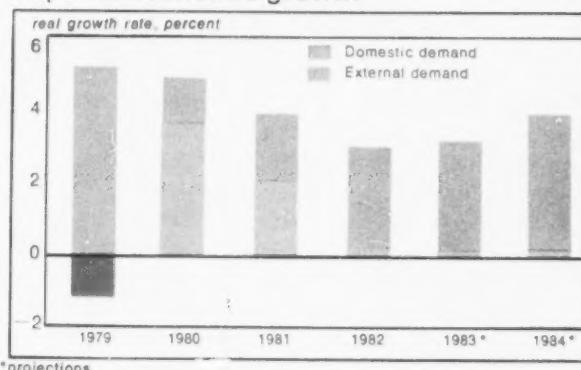
Recent statistics indicate that exports may have bottomed out and in all likelihood will respond to the pickup in activity in the United States and Europe in coming months. For 1983 as a whole, however, the increase in exports is likely to be a relatively modest 6%, with most of the rise contributed by price changes rather than higher volumes. Imports in value terms are projected to increase just over 1% in 1983. The oil import bill will fall drastically, with oil prices down some 15%. Government steps to boost imports are likely to have little effect, and non-oil imports are expected to rise only modestly as the economy recovers. As a result, the trade surplus is projected to expand to \$25 billion. And assuming only a small widening of the deficit on services, the current-account surplus is expected to climb to around \$13 billion.

Reflecting Japan's chronic excess of domestic savings over investment and the likely further liberalization of capital flows, the capital account is expected to record another large deficit, although not as large as in 1982. Any decline in foreign interest rates is likely to be swiftly followed by a decline in Japanese rates, which will, in turn, moderate any inflow of capital. The overall balance of payments is expected to be in approximate balance in 1983, and—reflecting the easier stance of the U.S. monetary authorities—the yen is projected to average a somewhat stronger 230 against the dollar.

Policy quandaries

Over the past year, Japanese policymakers have faced a difficult dilemma. Because of the government's strong desire to pare the fiscal deficit, monetary policy has been essentially the only policy tool available to spur weak domestic demand. However, any relaxation of monetary policy has only led to a weakening of the yen and heightened protectionist pressures. After stimulative money growth in the first quarter of 1982, Japanese monetary policy has turned successively less expansionary, as concerns have mounted over the weakness of the yen. And despite a dramatic appreciation of the yen from mid-November to mid-

The changing forces behind Japan's economic growth



January, the less-expansionary monetary stance appears to have been carried over into 1983. Next month, however, is an election month, and with the domestic economy still weak and a record high rate of unemployment, pressures for a discount-rate cut have intensified. The Japanese authorities seem unlikely to cut the discount rate before a decline in U.S. rates gives them the leeway to do so without weakening the yen. However, the Bank of Japan is expected to seize any opportunity to ease monetary policy as soon as it is presented. Still, unless Japanese policymakers undergo another change of heart, any expansionary monetary tendencies over the next year are likely to be tempered by concern over the behavior of the yen.

On the other hand, fiscal policy may well be moderately more expansionary in coming months. The government finally has conceded that its goal of balancing the budget by the end of fiscal 1984 cannot realistically be achieved, and no new goal has been set. This gives the government some room for fiscal expansion. Although the budget for fiscal 1983 is unquestionably austere, political considerations, as well as concern about the domestic economy, prompted the announcement on April 5 of a package of stimulative measures. Similar programs in the past have supported existing levels of economic activity but had little stimulative effect; this package is not expected to be any different.

Potentially more significant, however, is the government's promise to cut income taxes during fiscal 1983. Persistent problems in selling Japanese government bonds make it difficult to see how income taxes can be cut significantly this year without first laying the groundwork for a new tax to offset the revenue loss. And given probable delays in implementation, a tax cut is unlikely to have a major impact in 1983. Still, depending on how the revenue loss is offset, such a cut could be significant, since it would be the first true fiscal stimulus undertaken by the Japanese in a number of years.

Melanie L. Lau



CHASE

International Finance

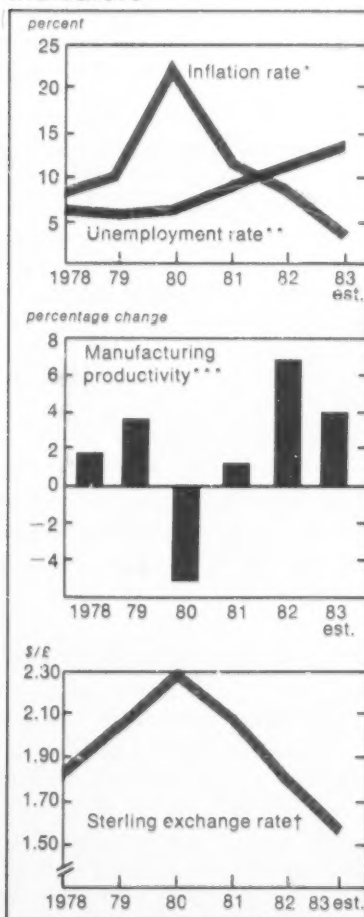
Vol. XVIII, No. 11
May 23, 1983

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1A 5/26/83

The U.K. Election and Downside Risk for Sterling

Selected U.K. economic indicators



*year over year, May consumer price index

**May rate, old definition

***second quarter over second quarter

†average of daily figures for May

British Prime Minister Thatcher's decision to call an early election for June 9 obviously was not made lightly. The Conservatives' ambitious policy program of expenditure cuts, tax reductions, and monetary restraint took much longer than expected to implement and has been disappointingly slow to take effect. Only in the past several months have the painful policies of the last four years begun to make headway.

The British economy is now rebounding from the recession, and the business community has grown markedly more optimistic. The underlying rise in unemployment has become quite small. And most important, inflation has slowed to about 4%—its lowest level since the mid-1960s. But while the opinion polls have consistently shown the Conservatives well ahead of the other parties, there have been gnawing doubts over how long that position can be maintained. With the possibility that the economic indicators could worsen before 1984—inflation, in particular, is almost certain to reaccelerate from its current level—it made good sense to call an election now.

The decision, however, is not without risk. Election day is still some time away, and previous campaigns have seen significant swings in voter sentiment. There is a possibility that the electorate will decide that the price of Mrs. Thatcher's success in taming inflation and boosting productivity has been too high to warrant another five years of her leadership.

A Thatcher loss would likely mean a setback for the British economy in the long run—and for the pound almost immediately. All signs are that should the Labor Party win the election, it would adopt radically different policies in such areas as public spending, taxation, nationalization of industries, exchange controls, and British membership in the EEC. This would almost certainly cause sterling to come under heavy selling pressure. A hung parliament—perhaps with an alliance of the Social Democrats and Liberals holding the balance of power—would result in a similar, though less-pronounced, selloff of the pound.

A win by Mrs. Thatcher, on the other hand, would strengthen sterling, although not as much as casual comparisons with the aftermath of the 1979 election might suggest. At that time, oil prices were rising sharply; now they are flat and show some signs of falling. Also, in 1979, Mrs. Thatcher offered a startling break with the previous government's attitudes; this certainly would not happen this time around. Moreover, the need to limit inflation via exceptionally tough monetary policy has virtually disappeared. All in all, the foreign-exchange markets would probably react to a Thatcher reelection with relative calm.

Ireland's stringent policies beginning to show results.

Italy still in need of an upturn, slower inflation, and a lower budget deficit.

Some economic progress in Denmark.

Bolivar devaluation adds to the problems of the Netherlands Antilles.

The tough policies that a new budget imposed on the Irish economy in February are now beginning to pay off. At a cost of virtually no growth in real GDP, the current-account deficit is being steadily reduced. Latest forecasts from the Department of Finance point to a shortfall of about 350 million pounds—some 3% of GDP, compared with 8.5% in 1982 and 14.5% in 1981. The year-on-year inflation rate was 12.5% in the first quarter of 1983 versus an average rate of 17.1% last year. Public-sector pay negotiations are now in progress and the prime minister has already brought strong pressure to bear on the unions in an attempt to bring wage increases down to average European levels. If world economic activity picks up during the next twelve months and thus expands Ireland's export markets, the country's prospects could be markedly improved by the end of 1984.

Although output appears to have bottomed out or started to rise in much of the rest of Europe, Italy's recession continues. Industrial output fell by 1.5% in March—the fourth consecutive monthly decline—bringing the year-on-year drop to 9.2%. Survey data on industrialists' inventories and orders also show no signs of an upturn. However, inflation—although currently at an annual rate of over 16%—appears set to come down. Moreover, the trade deficit narrowed sharply in March, bringing the first quarter shortfall to some 4.1 trillion lira, compared with 5.6 trillion in the same quarter a year earlier. These developments, combined with the relative strength of the Italian lira following the EMS realignment in March, have allowed the Bank of Italy to reduce the discount rate by one percentage point to 17%. No fiscal policy initiatives are expected to take place before the end of June when the country faces general elections. And the new government—again likely to be a coalition—will still face the daunting task of reducing inflation and the public-sector deficit (now over 15% of GDP) without further postponing an upturn, now expected for the latter part of 1983.

Despite still-serious problems, the Danes are becoming more optimistic about their country's economic prospects. The Economics Ministry's annual survey, published in April, has revised its forecasts for the 1983 budget deficit down to 56 billion kroner from 69 billion kroner, with further improvements projected for 1984. GDP growth is expected to pick up through this year, resulting in a year-on-year increase of 1.5%. At the same time, the current-account deficit is expected to fall to 14.5 billion kroner from 20 billion kroner in 1982. Wage increases will be held to about 6% in 1983 and the annual inflation rate could fall to the same level by mid-year. This optimism is being reflected in interest rates and bond prices. The official discount rate has been reduced to 7.5%—the lowest rate since 1975—and most bank lending rates have been cut by three percentage points. Bond prices have soared and effective yields have fallen from 22% at the end of last year to about 15% today, while stock prices have risen by 32%. All this represents a striking turnaround from the recent past. But the Danes are well aware that the economy must continue on the same trend for several years before they can begin to reduce their huge overseas debt, which—even on a net basis—now equals 33% of GDP.

The economy of the Netherlands Antilles—already hard hit by world recession and the slump in world oil demand—received another blow from the February devaluation of the Venezuelan bolivar. The Venezuelan devaluation nearly doubled the U.S.-dollar cost of travel for Venezuelan tourists. As a result, their visits to nearby Curaçao and Aruba—two of the six islands that make up the Netherlands Antilles—have come almost to a halt, dramatically affecting hotel and restaurant business, retail trade, and airline revenues. In addition to tourism, the economy of the Antilles is heavily dependent on offshore banking and on oil refining and shipping—sectors that have suffered declines as a result of the global recession and weak world oil markets. These trends suggest a somewhat gloomy business outlook in 1983 for this federation of islands. However, development aid from the government of the Netherlands should help soften the downturn.

Brazil showing a better trade balance in a slow economy.

Despite the continuing problems of economic adjustment and inadequate external liquidity, Brazil is making some headway in improving its foreign trade situation. A strong \$606-million surplus in April pushed the trade balance for the first four months of 1983 into the black by \$1.45 billion—a striking increase over the scant \$70-million surplus for the comparable four-month period in 1982. The April trade performance was partly the result of stepped-up devaluations of the cruzeiro and improved agricultural sales, which led to a 17% year-over-year increase in export earnings. In the same month, imports fell 21% owing to the general slowdown of the economy and reduced purchases of foreign petroleum. Brazil still faces a number of economic difficulties: Because of demand-restraining policies, industrial production is at low levels; unemployment remains troublesome; and inflation is running at more than 100% per annum. Nevertheless, the Brazilian authorities have focused on the attainment of a substantial trade surplus this year as a key goal. Thus, fiscal and monetary policies are likely to be increasingly directed in that direction.

Despite strict strategy, Taiwan's budget will still show sizable shortfall.

By the end of this month, Taiwan is expected to approve a tight budget for fiscal 1983-84, which begins July 1, in an effort to help restrain inflation. Total state spending will fall by 4.5%—the first decline in Taiwan's history. Even so the deficit is projected to rise 19% from fiscal 1982-83 to 34 billion New Taiwan dollars, as tax revenues are scheduled to fall 11.4% and total revenues by 6.6% following tariff reductions. As large as the deficit is, it may be difficult for Taiwan to achieve its budgetary targets, since these budget projections are based on an optimistic 5.5% real growth assumption. As a result, the realized deficit may be even larger than that forecast.

Oil-market slump slows Singapore growth, but government spending helps pick up the slack.

Real economic growth in Singapore slowed to 6.3% last year from 9.9% in 1981, and will probably decelerate further this year to around 4%-5%. The world recession has weakened the market for Singapore's manufactured exports, particularly consumer electronics. However, a more important depressant of economic activity has been the troubled oil market. The oil-refinery industry—Singapore's largest in terms of investment and sales—is shrinking rapidly because of the downturn in world oil demand and because of efforts by Indonesia to build up its own refineries. Other industries have been affected as well, including oil-rig manufacturing and oil-exploration services. The Singapore slowdown would be even more severe were it not for an expansionary government budget, with large outlays for housing and education. Late this year, ground will be broken for a new subway system and this is expected help to stimulate the economy in 1984 and 1985.

Ivory Coast: success in reducing inflation, budget deficit; current account still a problem.

Despite significant policy-directed internal adjustments in its economy, the Ivory Coast is expected to show only a marginal improvement in its external accounts. An austerity program under IMF supervision succeeded both in bringing the rate of inflation down well into the single digits and in narrowing the budget deficit to 8.9% of GDP in 1982 from 12.8% in 1980. This year, the fully-functioning Espoir oil field is projected to generate fiscal revenues to reduce the budgetary deficit further to 6.2% of GDP. Oil-sector activity should also help reverse the economic decline of the past two years to real growth of around 2%-3%. A substantial turnaround in the external sector, however, seems destined to be postponed once again. The declining prices for the country's main exports of cocoa and coffee that had depressed export receipts since 1980 appear to be rebounding. But this year's higher prices will be offset by sharply lower production owing to widespread drought and bush fires. Thus, despite a recession-induced decrease in the value of imports, the current account—aggravated by rising interest payments on the foreign debt—can be expected to remain nearly \$1 billion in deficit.

Shift in Bank Asset Portfolios

The coincidence of a major slowdown in corporate loan demand and the huge inflow of funds into money-market deposit accounts (MMDAs) has forced dramatic changes in commercial-bank asset portfolios over the past several months. Since mid-1982, there has been a substantial reliquification of bank assets and an impressive shift away from commercial and industrial (C&I) loans in favor of U.S. Treasury securities. The current outlook suggests this trend is not likely to be reversed in the near future and could step up competitive bank lending pressures before the year is out.

Growth over the last six months in commercial-bank C&I loans slowed to an annual rate of 2%—compared with 16% in the first half of 1982—largely as a result of corporate efforts to clean up battered balance sheets. During much of 1982, firms were stuck with slack sales and unwanted inventories, forcing them to borrow short-term funds from banks or the commercial-paper market. But thanks to the sharp inventory liquidation that began late last year and other changes in the economy, the heavy reliance on short-term debt has been greatly alleviated. The marked decline in corporate bond yields over the last few months has encouraged many firms to fund out their debt. In addition, the prolonged stock-market rally since late last summer has enabled many firms to pay down much of their debt and obtain an in-

creased portion of their funds through equity financing. The result has been a striking decline in the demand for bank credit.

At the same time, bank deposits have climbed sharply. Since last July, deposits have risen 13%—largely as a result of the introduction of MMDAs last December. Because this tremendous inflow of funds has come in a period of slack loan demand, banks have had to find alternative investments. The favorite—at least for the time being and particularly for the regional banks—appears to be U.S. government securities. Total bank holdings of Treasury securities, which grew at only a 2% rate in the first half of 1982, have soared at a 75% rate since July. The amount of cash on hand has also gone up significantly since mid-1982.

This shift in relative asset holdings by commercial banks should continue through 1983. With slow growth expected in business investment, an optimistic outlook for corporate profits and retained earnings, and continued refinancing by firms that are making up for years of depressed stock and bond prices, the prospects for growth in commercial-bank C&I lending are bleak. This is likely to encourage increased competition among the banks for corporate loans. At the same time, banks can be expected to be on the lookout for other alternative assets for their portfolios.

Robert S. Smith

Consumers Coming on Board

On the surface, the 2.5% rate of real growth reported for the first quarter makes the U.S. economic recovery look pretty anemic. In fact, the details of the data are quite encouraging. Along with more-recent information, they show important improvement on two counts: Major progress has been made in bringing down business inventories that had been much too high in relation to sales; and consumer spending (about two-thirds of GNP) is showing signs of renewed vigor.

It has been obvious for some time that the balance between developments in business inventories and consumer spending would determine the degree and shape of the early stages of this economic recovery. Trends in other sectors of the economy are pretty well established for the time being. Residential construction and military spending are strong. But they are a quite small part of the total. Three much larger sectors—capital spending, exports, and non-military government purchases—are flat-to-down, and likely to remain so at least through most of 1983. These three weak sectors account for three times the economic activity represented by house construction and military purchases. Hence, the key question has been: Could consumer spending grow in spite of income losses resulting from inventory reduction and weakness elsewhere in the economy? It was touch and go through most of the winter. With the coming of spring, however, the news brightened a lot.

Business inventories were reduced by a record

amount in the fourth quarter of 1982, and by nearly as much in the first quarter of this year. By the end of March, the inventory-sales ratio had been cut from 1.55 last October to a much more comfortable 1.45. Reductions are continuing in some industries. But more and more companies now find their inventories insufficient to support the current rate of sales. So they are lengthening the workweek and calling back laid-off employees. Over March and April, 450,000 workers were added to non-farm payrolls. The average workweek in manufacturing rose by a full hour between February and April. And in April, industrial production was up by a huge 2.1%. Wage and salary income rose by 0.6% in March and 0.8% in April.

Consumers have responded enthusiastically to these improvements in their economic circumstances. After months of stagnation, retail sales grew by 1.7% in March and 1.6% in April. Furthermore, there are signs of additional sales gains to come. The index of consumer sentiment published by the Survey Research Center at the University of Michigan shot up in both March and April, reaching its highest level in several years.

It is unlikely that these developments presage an outright consumer boom. The high unemployment rate—still over 10% and expected to improve only slowly—will continue to serve as a damper on sales. But the trend has clearly turned up. The 10% cut in income taxes scheduled for July should help it along.

Richard W. Everett

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING					COUNTRIES		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in \$ million	12-month change	months of imports covered	use of MF credit, billions of dollars	current influences on payments	12-month changes		central bank rate Δ in U.S. dollars May 18, 1983	exchange rate in U.S. dollars	current monetary conditions			
												latest data	consumer prices						
Austria	No significant policy change likely from expected Socialist-Liberal coalition.	Dec.	- 6%	65.8	0	Mar.	5,048	+ 4%	3.3	0	Stronger demand in Germany contributing to Austrian current-account surplus.	Mar.	+ 3%	Mar.	+ 9%	3.75%	.0576	Schilling remains informally linked to DM.	Austria
Belgium	Private consumption forecast to decline again this year, but export and investment prospects improve.	Jan.	+ 1%	85.1*	-1.9%	Mar.	4,826	+21%	1.1	0	Current account showed provisional deficit of 122 billion francs in 1982.	Apr.	+ 8%	Dec.	+12%	9.50%	.0204	Interest rates fall.	Belgium
Britain	Consumer demand remains buoyant and some 2% GDP growth is expected this year.	Feb.	+ 3%	505.8	-2.0%	Mar.	11,423	-21%	1.4	0	Current account showed a 287-million pound surplus in 1983 first quarter.	Mar.	+ 5%	Feb.	+11%	10.06%	1.5595	No rise in interest rates expected before election.	Britain
Denmark	Real growth of 1.5% expected this year.	Dec.	+ 4%	55.9	-0.2%	Mar.	2,499	+19%	1.8	0	March's trade performance produced first-quarter deficit of kr518 million.	Mar.	+ 8%	Dec.	+11%	8.50%	.1141	Interest rates now at lowest level since 1975.	Denmark
Finland	Growth is expected to reach 2% this year, double last year's figure.	Dec.	- 3%	48.3	+1.4%	Mar.	1,127	-27%	1.0	8	First quarter 1983 showed a FMK 588-million trade surplus.	Apr.	+ 8%	Nov.	+18%	8.50%	.1842	Money market conditions have eased a little.	Finland
France	Tough austerity program designed to cut real domestic demand by 2%; unemployment set to rise.	Feb.	+ 1%	568.5	+0.3%	Feb.	17,112	-17%	1.8	0	Trade deficit expected to improve sharply after poor first quarter.	Mar.	+ 9%	Jan.	+11%	9.50%	.1353	Interest rates hold steady.	France
Germany	GDP resumes positive growth in first quarter, but recovery remains fragile.	Mar.	- 8%	659.7*	-1.1%	Mar.	49,840	+21%	4.0	0	Improved terms of trade forecast to raise current-account surplus.	Apr.	+ 3%	Feb.	+10%	4.00%	.4068	Interest rates bottomed out for time being.	Germany
Greece	Economy remained flat last year despite expansionary policies; inflation remains over 20%.	Nov.	- 6%	38.0	-0.7%	Mar.	917	- 3%	1.1	0	Current-account deficit expected to rise from last year's \$1.9 billion.	Feb.	+21%	Nov.	+21%	20.50%	.0119	Credit expansion remains high, especially to public sector.	Greece
Iceland	Fish catches down, export markets depressed; GDP to fall by 2.7% in 1983 after 3.5% decline in 1982.	n.a.	n.a.	2.8	+1.7%	Mar.	129	-37%	2.4	23	Current-account deficit to narrow this year but will still reach 6% of GNP.	Feb.	+68%	Nov.	+18%	28.00%	.0457	Inflation accelerating again; will reach 70% in 1983.	Iceland
Italy	Recession continues as investment weakens; election scheduled for June 26-27.	Mar.	- 9%	350.6	-0.2%	Mar.	14,219	- 4%	2.1	0	Trade deficit set to improve owing to recovery in rest of Europe.	Apr.	+17%	Oct.	+15%	17.00%	.00068	Interest rates decline moderately.	Italy
Netherlands	Government imposes further spending cuts in order to reduce growing public-sector deficit.	Feb.	- 2%	137.9*	-0.8%	Mar.	10,835	+17%	2.0	0	Gas export revenues decline, reducing trade surplus.	Apr.	+ 3%	Jan.	+10%	4.50%	.3617	Rates raised as guilder weakens after EMS realignment.	Netherlands
Norway	With oil prices still weak, GDP will remain flat this year.	Feb.	+ 1%	55.6	+0.8%	Mar.	5,885	- 3%	4.8	0	Trade remains in a healthy surplus.	Apr.	+ 9%	Nov.	+12%	9.00%	.1407	New proposals will allow small number of foreign banks.	Norway
Portugal	April election clears path for new economic measure.	Aug.	+12%	23.5**	+5.5%	Feb.	493	+29%	0.7	3	Republic raising \$300-million syndicated loan.	Jan.	+21%	Nov.	+15%	19.00%	.0101	M2 growth rose to 27.1% in November.	Portugal
Spain	Proposed 1983 budget deficit of 1,100 billion pesetas, lower than previously expected.	Nov.	- 1%	183.7	+0.3%	Feb.	7,165	-29%	2.9	0	Current-account deficit in 1982 declined to \$3.9 billion.	Mar.	+13%	Dec.	+11%	8.00%	.0073	March M3 growth was 15.3%; 1983 target is 13%.	Spain
Sweden	New official forecasts point to 1.8% rise in GNP this year.	Jan.	+ 2%	111.5	-0.7%	Mar.	3,455	+ 1%	1.5	0	Huge March surplus puts 1st qtr. trade balance kr2.7 billion in black.	Mar.	+ 8%	Dec.	+10%	9.00%	.1337	Discount rate cut to 8.5% on April 8.	Sweden
Switzerland	No growth expected this year.	Dec.	- 9%	99.4	+1.9%	Mar.	13,937	+ 9%	5.7	0	First quarter 1983 recorded trade deficit of SF2.4 billion.	Apr.	+ 5%	Mar.	+ 6%	4.00%	.4895	Monetary conditions tightened.	Switzerland
Canada	Recovery given boost by recently announced federal budget favoring private sector.	Feb.	- 3%	283.6*	-4.8%	Mar.	3,489	+60%	0.8	0	Current-account surplus will narrow as imports rebound faster than exports.	Mar.	+ 7%	Feb.	+10%	9.27%	.8126	Sharp inflation deceleration brings hopes of lower rates.	Canada
United States	Consumer spending picks up, leading economy into stronger recovery.	Apr.	+ 2%	3,059.3*	-1.7%	Mar.	23,123	+23%	1.1	0	Exports continue to slump, non-oil imports rise; trade deficit widening.	Mar.	+ 4%	Mar.	+11%	8.50%	—	M1 growth slowed in April, likely to reaccelerate.	United States

△most recently reported

*1982 **1980

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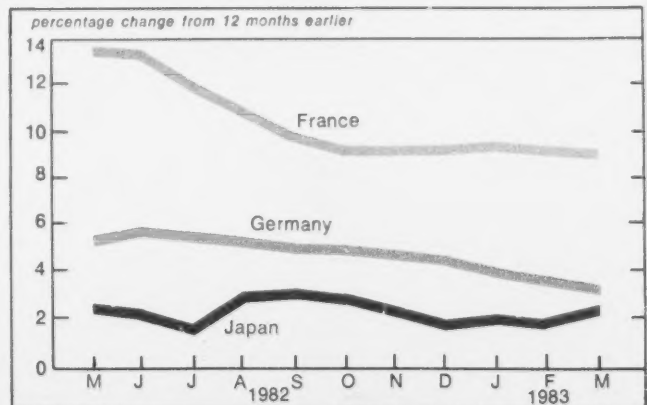
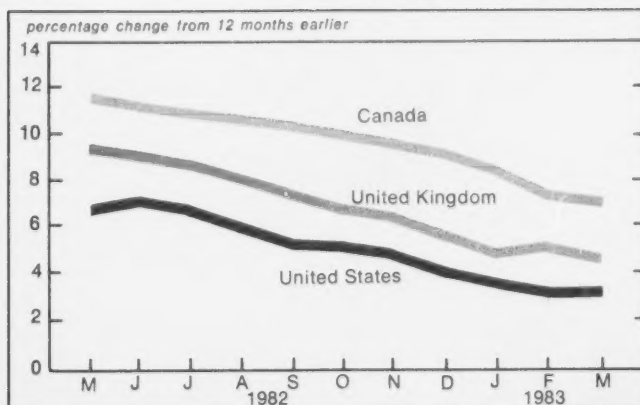
World Interest Rates

market rates as of May 18, 1983; bond yields as of May 13, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan																																																							
Central Bank Discount Rate	8.50	9.27	10.063 intervention rate	9.50	9.50	4.00	17.00 penalty rate 20.00	4.50	4.00	5.50																																																							
Day-to-Day Money	8.625 May 19	10.75	10.00	7.75	12.25	5.00	18.00	4.75	2.75 1-month Euro-Swiss fr. rate	6.063																																																							
Treasury Bills 91-day, Middle Rates	8.10	9.05	9.875	10.00	n. a.	n. a.	17.10 163 days	no dealing	no market	5.625																																																							
Commercial Paper prime, 3-month, asked	8.50 finance paper discount basis	9.20 finance paper 15% tax w/h	9.451	9.40 Certified	12.563 interbank	no market	no market	no market	no market	not traded																																																							
Bankers' Acceptances 3-month, asked	8.45	9.10 15% tax w/h	9.859	9.40 Certified	not traded	5.35	18.95	no market	4.625	no market																																																							
Government Bonds Long-term, new and old issues, average yield	10.60	11.50	10.48	10.05	13.705	7.83	18.29	8.28	4.40	7.04																																																							
Industrial Bonds prime, long-term, new and old issues, average yield	11.25 Aa Industrials	12.125	12.19	12.23	14.81	7.75	17.96	8.66	5.72	6.46																																																							
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.00	14.55	8.00	18.75 1/4 qtrly fee on outstg.	7.50	7.50	6.00																																																							
Bank Time Deposits 3-month	8.125 Cert. of Dep.	9.29	10.25	9.95	12.625	5.10	11.50	5.50 large deposits	3.50 residents only	3.75 20% tax w/h																																																							
Eurocurrencies 3-month, asked	9.063	9.375	10.375	no market	13.75	5.0625	no market	5.688	4.50	6.313																																																							
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8122	1.562	.0204	.1350	.4066	.0007	.3616	.4885	.0043																																																							
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	.246 D	1.204 D	1.336 D	4.741 D	4.230 P	7.028 D	3.540 P	4.831 P	2.793 P																																																							
<table><tr><td colspan="2">Eurodollar Deposits (London, interbank, bid) May 19</td><td colspan="4">International Arbitrage (3-month, hedged) + in favor of U.S. dollars</td><td colspan="3">Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under Over 7 yrs. DM Bonds 7 yrs. and under Over 7 yrs.</td><td colspan="2">Gold Price London afternoon fixing 442.75 (per fine ounce)</td></tr><tr><td>7-day</td><td>8.813</td><td colspan="4">U.S.-U.K. Treasury Bills</td><td colspan="3">—0.436</td><td colspan="2">10.50</td></tr><tr><td>1-month</td><td>8.875</td><td colspan="4">U.S.-Canada Treasury Bills</td><td colspan="3">—0.383</td><td colspan="2">10.75</td></tr><tr><td>3-month</td><td>9.00</td><td colspan="4">U.S.-Canada Finance Co. Paper</td><td colspan="3">—0.328</td><td colspan="2">7.25</td></tr><tr><td>6-month</td><td>9.063</td><td colspan="4">Eurodollars-U.K. Local Auth. Deposits</td><td colspan="3">+0.142</td><td colspan="2">7.50</td></tr></table>											Eurodollar Deposits (London, interbank, bid) May 19		International Arbitrage (3-month, hedged) + in favor of U.S. dollars				Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under Over 7 yrs. DM Bonds 7 yrs. and under Over 7 yrs.			Gold Price London afternoon fixing 442.75 (per fine ounce)		7-day	8.813	U.S.-U.K. Treasury Bills				—0.436			10.50		1-month	8.875	U.S.-Canada Treasury Bills				—0.383			10.75		3-month	9.00	U.S.-Canada Finance Co. Paper				—0.328			7.25		6-month	9.063	Eurodollars-U.K. Local Auth. Deposits				+0.142			7.50	
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.

Consumer price trends in selected industrial countries



Can Sterilized Intervention Work?

Exchange-rate volatility is certain to place high on the agenda of the economic summit in Williamsburg at the end of this month. Indeed, some agreement toward increased intervention by the major Western central banks aimed at dampening the violent exchange-rate fluctuations of the last few years may well emerge from that meeting. At first blush, intervention has intuitive appeal as a means of stabilizing exchange rates. In practice, however, it introduces a paradox that is difficult to resolve: Unless the intervening central banks also take offsetting monetary actions, they effectively give up control over their own domestic monetary policies. But if they do take these actions, the intervention may be fruitless.

Much of the current debate among economists, central bankers, and politicians on the "effectiveness" of foreign-exchange intervention implicitly assumes that the monetary policies of each of the participating players do not change. That is, the domestic monetary effects of the intervention are "sterilized" by offsetting monetary expansion or contraction, to enable each country to pursue the combination of interest rates and monetary growth rates that it would have followed in the absence of intervention.

There is good reason to believe, however, that exchange-rate fluctuations cannot be stabilized by sterilized intervention—at least for any period that is relevant for practical policymaking. This can be seen from a brief review of some basic principles.

The rationale for intervention

Problems arise from currency fluctuations because the prices of real goods and labor rarely adjust as quickly as the prices of financial assets. Consequently, exchange-rate fluctuations lead to changes in relative prices and relative labor costs either between one country and another or between one industry that produces tradable goods and another industry that produces only non-tradable goods. This then influences decisions on where and what to produce, and thus, affects output and employment—not always in the desired way.

Still, it is necessary to distinguish between exchange-rate fluctuations that occur in the short run—say within a day or a week—and medium-term currency swings that can last from several months to three years. Short-run exchange-rate fluctuations are not likely to affect business decisions regarding investment, production, or pricing and are therefore unlikely to have any material effect on the real economy. Of course, such short-run movements heighten financial risk and thus raise the cost of doing business, which may lead to some reductions in output. But the effect is small. Medium-term fluctuations, on the other hand, do affect business decisions.

Because of this, economists and central bankers have sought ways to eliminate, or at least minimize, exchange-rate fluctuations. On the surface, intervention—defined as the purchase or sale of foreign exchange in the open market by the central bank or monetary authority—appears to be an appealing means of stabilizing an exchange rate. It seems analogous to stabilizing the price of any commodity: buy for stock-building when the price is falling and sell from stocks when the price is going up.

The analogy, however, is incomplete because of the tight links between the foreign-exchange and money markets. When a central bank sells foreign exchange but does nothing else, it reduces the stock of money—strictly speaking, the stock of "high-powered" or "base" money. This reduces liquidity and tends to raise interest rates. Symmetrically, when a central bank buys foreign exchange against its own currency but takes no offsetting action, it raises the stock of base money in its economy, which increases liquidity and tends to reduce interest rates.

Thus, by stabilizing exchange rates without taking offsetting monetary action, central banks lose independent control of their own money stock and level of interest rates. In fact, it is this implicit subservience of monetary policy to an exchange-rate target that provides the adjustment mechanism by which systems of fixed exchange rates survive. The tightening of liquidity that results from intervention to support an exchange rate under downward pressure ultimately removes that downward pressure.

To the extent that foreign-exchange intervention compromises either interest-rate or money-growth targets, a central bank will seek to offset or "sterilize" these effects. For example, a central bank selling foreign exchange to alleviate downward pressure on its currency would foster a lower money stock and higher interest rates. If it sees this as undesirable, it will either buy securities in the domestic financial market or seek to restore domestic liquidity in some other way, perhaps by lending more to the banking system. Conversely, a central bank intervening to prevent an appreciation of its own currency will frequently take offsetting contractive action to ensure that domestic liquidity remains unchanged.

The problem is that sterilized intervention generally does not stabilize exchange rates. In theory, there is a special set of conditions under which sterilized intervention will have an effect. However, those conditions either: (1) apply only in the very short run—when exchange rate fluctuations do the least harm or good for the economy, or (2) are empirically unrecognizable in any longer-run time frame relevant to central-bank policy decisions.

To understand why this is so, consider the example

Can Sterilized Intervention Work? *(continued from page 7)*

of a central bank that sterilizes the effects of intervention to stabilize interest rates. Arbitrage ensures that the forward premium or discount of one currency against another will closely approximate the interest-rate differential between the two countries for instruments of equal maturity and risk. This relationship is known as interest parity. If the central bank fixes domestic interest rates, then—for a given level of foreign interest rates—the forward premium or discount is determined. It follows that any attempt to change the spot rate will provide profits to arbitrageurs unless the forward exchange rate is also altered.

Under "normal" conditions, the forward rate represents the market's "best guess" of the future level of the spot rate. This is determined by the information available to the market at the time the forward rate is negotiated—including information on actual and expected inflation rates, trade balances, actual and expected monetary policy, and anything else that, in the market's eyes, affects exchange rates. If all of this information is available to all market participants, then—unless market participants are extremely risk averse—the equilibrium forward rate is equal to the expected value of the future spot rate for currencies of similar risk characteristics. If this were not the case, speculators could profit by buying or selling forward until the forward rate adjusted to the market's expectation of the future spot rate.

Because of the interest-parity relationship, the key to successful sterilized exchange-rate stabilization is the central bank's ability to influence the forward rate. There are only two conditions under which this can be done: (1) when, under extraordinary circumstances, the forward rate is not equal to the market's expectation of the future spot; and (2) when the central bank has superior information to the market and thus knows in advance of the market the direction in which the forward rate will change.

The first case prevails when there is an insufficiency of speculators. This may occur in the extreme short run when all available information has not had time to be evaluated by the market or when the difference between the forward rate and the expected future spot rate is so small that the risk for the potential speculator outweighs the expected profit. It is also possible that insufficient longer-run speculation might occur because market operators are extremely risk-averse. In such a case, the forward rate would differ from the expected future spot rate because market participants are unwilling to act on their "best guess." Then the central bank could influence the forward rate by intervention.

The second situation when stabilization is successful occurs when the central bank has information in

advance of the market. In this case the central bank can tolerate a temporary disequilibrium in the exchange and money markets, knowing that the forward rate will move to its equilibrium level once the information available to the market is amended. This is not a frequent occurrence, however. A number of academic studies have concluded that central banks are not often successful in outguessing the market.

In the first situation, the problem is that, in practice, it is impossible to determine ahead of time whether a change in the forward rate is due to an insufficiency of speculation or to a change in the market's information. It is, therefore, impossible for the central bank to decide whether its intervention will stabilize the rate by moving the forward rate toward the expected future spot rate, or whether it will merely act against the market. The latter outcome would, in effect, provide a gift to speculators and arbitrageurs, and ultimately destabilize the spot rate by exhausting central-bank reserves. As for the second situation, it occurs too infrequently to be of major importance. The overall conclusion is that sterilized intervention will not generally stabilize exchange rates.

Which kind of instability?

Exchange rates can be stabilized, of course, if central banks are willing to subordinate their monetary policy to an exchange-rate target. They would then no longer commit themselves to stabilizing domestic interest rates, nor would they have the freedom to choose any path for the rate of growth of the money supply. Under such conditions, however, unpredictability of information would show up as instability in interest rates rather than in exchange rates. Since the interest rate represents a price as much as the exchange rate does, it is not immediately clear that interest-rate instability is preferable to exchange-rate instability. In any event, post-1973 history has shown that most governments are not willing to give up control over interest rates and money-supply growth, and thus will ultimately prefer exchange-rate adjustments over interest-rate adjustments.

The real key to greater financial stability—be it in interest or exchange rates—is greater predictability of information. Of course, certain random shocks—such as political crises, oil crises, or natural disasters—cannot be avoided. But much of the recent instability has been caused by shifts in government policy and by the market's necessarily imperfect understanding of how policymakers are likely to react to certain economic events. Greater financial stability thus requires, among other things, a steadier and more predictable set of government policies. In Western democracies, this, in turn, requires a steadier and more predictable set of electoral preferences.

*George de Nemeskeri-Kiss
Chase London*

The Eastern Bloc Gets By Without a Summit

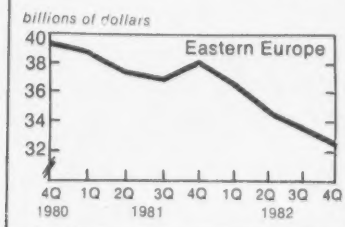
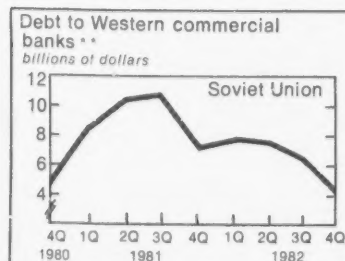
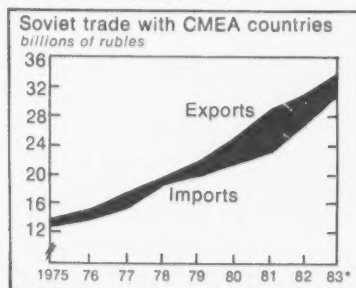
The squabbles over exchange rates and budget deficits that clouded the Williamsburg summit seem insignificant compared with the current conflicts within the Council for Mutual Economic Assistance (CMEA). Problems among leaders of the Soviet Union and Eastern Europe are so severe—and compromises so elusive—that the economic summit scheduled by the Eastern bloc for this spring had to be indefinitely postponed.

CMEA economic summits generally serve to legitimize changes in CMEA rules or programs previously negotiated. Currently, many East Europeans are dissatisfied with the bilateral trade procedures and cumbersome clearing arrangements that have frustrated multilateral trade and financial flows within the region. Although demand for many CMEA products—particularly fuels, raw materials, and food—is high, the transferable ruble, which is the clearing unit in intra-CMEA trade, cannot command these goods without explicit authorization. As a result, the growing volume of multilateral trade within the CMEA is transacted at world-market prices, cleared in convertible currencies, and at times brokered through Western intermediaries. In 1982, when intra-CMEA trade grew by 10.5%, the total assets of IBEC (the CMEA clearing bank) actually fell 8%. In addition, the Soviet Union, the dominant creditor in the bloc, has preferred “supra-national coordination” of national investment and trade programs over any trend toward multilateral trade and finance.

Conflicts over resource transfers—namely, the level of allocation of Soviet subsidies to Eastern Europe—present even more serious problems. Driven by a five-year moving-average pricing formula, the value of Soviet net exports to the CMEA surged to 5 billion rubles in 1981 from 2.9 billion in 1980. Soviet insistence on a reduction of this burden in net terms led to a 16.5% increase in CMEA exports to the USSR in 1982, cutting the deficit to 3.7 billion rubles; further reductions are anticipated in 1983. To complicate financing problems, there has been no give on the part of the Western capital markets. East European net debt to Western banks has dropped nearly \$7 billion over the past two years.

So far, the Soviet Union has been successful in its bilateral negotiations with Eastern Europe and has sought to avoid an active summit that might collectively examine the issues of resource transfers. To the surprise of some, the economies of Eastern Europe did not collapse under the severe circumstances of 1980-82, and therefore, the Soviet strategy has worked. Consequently, any CMEA reforms will probably be delayed until similar debates within the Soviet economy itself are settled.

CMEA trade and debt to the West



*forecast
**net liabilities

*Looking beyond
Switzerland's current
economic indicators.*

*Stringent policies yield
optimistic forecast
of Belgium's
current account.*

*Portuguese economy
still in need of
a firm hand.*

*Korean economy
showing growth rebound,
still low inflation.*

At first glance, recent statistics on the Swiss economy seem somewhat disappointing: The trade deficit in each of the first four months of 1983 has been considerably wider than in the same month of 1982. Consumer prices have been about 4.5% above last year's levels, while M1 remains about 15% higher than its level in the first quarter of 1982. These data are misleading however. The trade deficit reflects imports of new aircraft from the United States, together with a rebuilding of oil inventories that followed the rundown of stocks at the end of 1982 in anticipation of lower oil prices. Thus, the balance of trade is expected to improve over the year while Switzerland's traditional surplus on invisibles will give the country a current-account surplus of some 5 billion Swiss francs. The consumer price index is strongly influenced by housing costs, which will be virtually stable over the near term and can be expected to bring down the measured inflation rate to 3% by year end. Finally, today's high year-on-year money-supply numbers are primarily a reflection of last year's rapid growth. Most forecasters agree that the Swiss National Bank is likely to hold 1983 money growth very close to its stringent targets. This picture suggests that the Swiss franc should once again begin to appreciate against the dollar before the year is out.

The restrictive policies introduced by the government of Belgium some sixteen months ago—devaluation, cuts in real wages, and tighter control of public expenditures—are beginning to bear fruit. Provisional estimates indicate that the current-account deficit last year fell to 122 billion Belgian francs, from 150 billion in 1981. The improved trend that set in during the second half of 1982 is expected to continue this year, resulting in an even sharper reduction in the deficit for 1983 and a chance that the current account will be virtually balanced by 1984. This forecast assumes, however, that demand continues to recover in Germany and that the Martens government succeeds in implementing a planned further reduction in real wages this year. A stronger current account would then relieve incipient pressure on the Belgian franc in the European Monetary System, allowing lower Belgian interest rates and a badly needed recovery in private capital investment.

Although Portugal's April election gave the Socialist Party the largest number of seats in the new parliament, it did not produce an absolute majority. Discussions have now continued for over a month between the Socialists and the Social Democrats in an attempt to form a coalition government. While final agreement has not yet been reached, progress is being made in securing external funds to finance Portugal's current-account deficit, which reached nearly \$3.3 billion in 1982. The Bank for International Settlements has provided a \$400-million short-term bridge loan, and a consortium of international banks has just raised a \$300-million syndicated loan. In April, the previous government devalued the escudo by 2% and increased the monthly crawling peg adjustment to 1% in a delayed reaction to the March EMS realignment. Although this was accompanied by a rise in commercial-bank interest rates, further deflationary policies will be necessary if the balance-of-payments deficit is to be reduced significantly.

The early months of 1983 have brought some encouraging signs of improvement in the Korean economy. Industrial output rose by approximately 14% in the first quarter. And while exports in the first four months of the year were only 1.4% higher than in the same period of last year, order books in some industries have been improving. In particular, ship-building orders are up sharply. The Korean government recently announced that first quarter GDP growth was over 9% at an annual rate and officials are projecting 7.5% growth for the year as a whole. Meanwhile, the rate of inflation has remained extremely low. The consumer price index for April rose at a year-over-year rate of only 4.3% and wholesale prices were up only 1%. Thus, the large increase in the money supply that occurred in the third quarter of 1982 has helped to stimulate recovery but so far has not generated any inflationary consequences.

*Decline in imports
will counterbalance
Peru's export setback.*

The adverse weather conditions suffered by Peru in the first few months of the year will have a major impact on 1983 exports. First-quarter exports were down 17% from the same period in 1982 owing to damages caused by rains, floods, landslides, and—in southern Peru—droughts. Earnings from cotton, Peru's second most important cash crop, were off 89%, while minerals and petroleum export earnings fell 24% and 20%, respectively. Since only part of the damage is recoverable, total exports for the year are now likely to reach only \$2.9 billion—markedly lower than the \$3.3 billion projected only a few months ago. As far as Peru's current-account balance is concerned, however, a decline in imports will completely offset the reduction in exports. First-quarter imports dropped 29% below last year's levels. Capital goods showed the greatest loss, owing to the sharp slowdown in economic activity and declines in both public-sector and foreign investment. Expectations are that imports for the year will also total \$2.9 billion. With the services deficit projected at \$1.3 billion and net transfers at \$200 million, Peru's current-account deficit is likely to reach \$1.1 billion this year.

*Honduran economic
turnaround awaits
resolution of region's
political crisis.*

The political crisis in Central America has taken a high toll on the Honduran economy. GDP stagnated in 1981 and 1982, and both private investment and exports fell drastically. This is all the result not only of recession-depressed prices for export commodities but also of the political turmoil that has scared away private investment. The government is successfully implementing an austerity program along the usual IMF guidelines. Honduras will also receive \$250 million of foreign loans and aid this year. But neither the IMF nor foreign assistance will reverse the deterioration of the Honduran economy until the political crisis in Central America is resolved.

*Additional development
rephasing ordered
to ensure Indonesian
creditworthiness.*

In a further attempt to adjust to the consequences of the steep drop in oil prices, the Indonesian government recently ordered the review of all government projects financed by commercial credits or requiring foreign exchange. This dramatic move goes even further than the government's previous decision to rephase several major development projects, including a \$1.6 billion olefin petrochemical complex, a \$1.5 billion aromatics plant, a \$1.35 billion oil refinery, and a \$600 million alumina refinery. With regard to those projects, the government had indicated that it would complete only those phases of the projects that it could afford—such as engineering design; actual construction work in many cases will be delayed indefinitely. Now other projects are likely to be similarly affected. By reducing import requirements, the rephasing of the country's development projects is expected to ease pressure on the current-account deficit, which soared to \$6.8 billion in the year ending March 31. Thus the government's latest action is a further strong signal that the government is determined to live within its means and maintain its creditworthiness.

*UAE surplus shrinking
despite official measures
to keep tabs on spending.*

The United Arab Emirates (UAE) registered an estimated current-account surplus of \$6 billion last year, down noticeably from just over \$9 billion in 1981. This occurred despite a 4% drop in merchandise imports to about \$9.3 billion (c.i.f.). The decline in the surplus was attributable to a 17% fall in the UAE's merchandise exports to \$18.1 billion, the result of significantly lower oil revenues reflecting weak world demand: Not only did petroleum production shrink by 19% to 1.2 million barrels per day (mbd) but the weighted average oil export price also fell by 5% to about \$34.35 per barrel. Even if state budget cutbacks hold merchandise imports and other payments to last year's level, the current-account surplus will shrink further this year because oil revenues are projected to fall again. The weighted average price has already been cut to \$29.30 per barrel as of March 1, and continued soft world demand will probably keep the UAE's oil output close to its OPEC-assigned quota of 1.1 mbd. Consequently, it is unlikely that the UAE's surplus will exceed \$3 billion in 1983.

The Increasing Irrelevance of M1

In Pavlovian fashion, the money markets have reacted to the more-than-\$13-billion rise in M1 since April 27 by driving up interest rates. Short-term rates have posted gains in the range of 20-35 basis points since this most recent acceleration in M1 growth began.

The response of the market to this unexpected upturn in the money numbers, however, has been a bit overdone. The days are long gone since the M1 monetary aggregate was a reliable indicator of future Federal Reserve policy and the course of the economy. The measure is increasingly plagued by distortions, either from technical influences or possibly as a result of a shift in money demand. As a consequence, the number has lost most of its informational content.

This is especially true of the post-April 15 numbers, which have been particularly distorted by interest-payment reflows. Because of the institutional structure of the debt markets and the borrowing patterns of the government sector, debt-servicing flows tend to swell the level of monetary balances. Normally, the market simply dismisses these reflows as a seasonal phenomenon that will be purged in the process of seasonally adjusting the data. This time, however, unique trends have come into play that have magnified the impact of the reflows.

First, the run-up in interest rates over the past two years has resulted in a corresponding increase in in-

terest reflows to households. Interest income as a proportion of personal income rose from just over 12% in 1980 to nearly 14.5% in 1982, and so far in 1983 it is hovering around 14.3%. These record reflows are not fully offset by the Fed's seasonal-adjustment factors, which are based on much smaller levels of interest payments. Consequently, the reflows have induced swelling of the monetary aggregates around payment periods.

Second, because the federal, state, and local governments had record deficits to be financed, the quantity of coupon securities issued in 1982 reached unprecedented levels. The federal government was a net credit-market borrower of \$161.3 billion in 1982, almost double 1981's \$87.4 billion. At the same time, state and local governments tapped the credit markets for \$47.2 billion last year, more than twice the \$22.3 billion raised in 1981. This trend necessarily implies that record interest payments will be made in 1983. And these payments will continue to swell the monetary aggregates as funds work their way through the clearing process. Moreover, the crunch usually comes in the April-June period because federal, state, and local governments time their debt servicing to fall shortly after tax collection dates.

Third, individual investor participation in the government and municipal securities markets has gone up in recent years. This is especially true in the

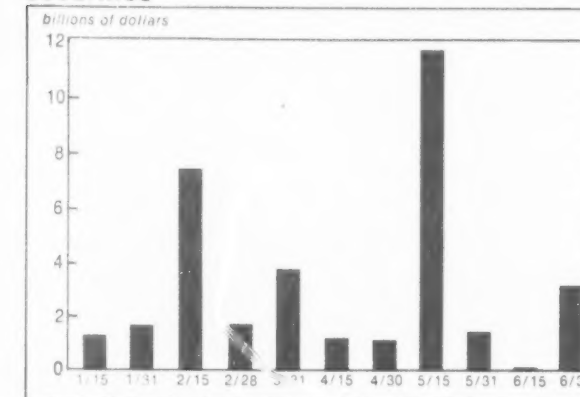
municipal market, where individual investors have become a dominant supplier of new funds. This is significant for the measurement of M1 because these investors—unlike commercial banks—tend to let interest accumulate in deposit accounts rather than immediately reinvesting in comparable types of debt instruments. The reason for this is that individuals' portfolios usually involve less-active management and higher transaction costs.

While this reflow effect might explain the most recent acceleration in M1 growth, it does not account for the persistent rise since the fourth quarter of 1982. The rapid M1 growth over the last 10 months in all likelihood has stemmed from the Fed's accommodation of changes in money demand. In contrast, the bloating of the money supply that has resulted from the concentration of interest reflows is a temporary phenomenon that will eventually subside.

In the interim, however, the swelling of M1 could have some adverse policy implications. The market, viewing the above-target money-supply growth, drives up interest rates in anticipation of a Fed tightening—or out of fear that the Fed has succumbed to an unabashed inflationary stance. In either case, the move risks aborting the recovery and placing the world financial system under renewed strains.

While there are reasons to believe that the money growth of the past 10 months has not been inflationary thus far—since it stems from balances holders do not intend to spend immediately—it nonetheless carries inflationary potential. The risk of renewed in-

Interest due on marketable U.S. Treasury securities*



*Notes and bonds, all maturities

flation comes later when the money demand and technical distortions subside. The periodic jumps in interest rates are more the result of fears bred by uncertainty over Fed actions in the short run than concern over future inflation. At present, the only guide the market has to monetary policy are the unreliable and distorted monetary aggregates. To wean the market from the M1 fixation, the monetary authorities need to outline clearly and thoroughly the policies they intend to follow and to define how the monetary aggregates figure into policy strategies. Unless they do this, they and the economy will be captive to the uncertainty-induced waves of optimism and pessimism that are sweeping through the financial markets. Vincent G. Salvo

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
			6 months ending	12-month change	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars June 1, 1983	change from year earlier		current monetary conditions
													latest data	consumer prices	latest data	money supply(M1)				
Asia	Bangladesh	Government's favorable attitude attracting new foreign investment proposals.	Dec.	+12%	10.8*	120	Mar.	246	+ 17%	1.4	406	Western donors pledge \$1.7 billion in aid for fiscal 1983-84.	Dec.	+ 5%	Dec.	+11%	.0415	- 25%	Private-sector credit up sharply in early 1983.	Bangladesh
	Burma	Government slates cutback in investment programs to halt reserve loss.	Dec.	- 29%	5.8*	159	Mar.	53	- 75%	1.8	70	Overall deficit widened markedly in fiscal 1982-83; reserves down sharply.	Dec.	+ 4%	Aug.	+ 9%	.1279	- 3%	Kyat remains pegged to SDR.	Burma
	China, People's Republic	Industrial output in first quarter was 6.9% above previous year.	Dec.	+ 3%	260.0	260	Dec.	11,339	+125%	8.0	492	IMF will be repaid ahead of schedule this year.	Dec.'81	+ 3%	Dec.	+ 8%	.5025	- 3%	Investment spending soared in late 1982, early 1983.	China, People's Republic
	Hong Kong	With property and stock markets depressed, hopes pinned on export recovery.	Mar.	+ 4%	24.2	4,695	n.a.	—	—	—	—	First-quarter trade deficit falls as exports start to pick up.	Mar.	+ 11%	Mar.	+15%	.1377	-21%	Rates boosted to halt HK dollar tailspin.	Hong Kong
	India	Industrial licensing restrictions relaxed further to spur production.	Sept.	- 9%	161.4*	236	Oct.	3,980	- 19%	3.8	2,876	Import policy eases restrictions for exporters, tightens in other respects.	Feb.	+ 9%	July	+ 8%	.1000	- 9%	Cash-reserve ratio raised to absorb excess liquidity.	India
	Indonesia	Government rephasing of development projects will depress domestic activity.	Aug.	-15%	81.5	541	Jan.	3,060	- 44%	2.3	70	Project rephasing will help to narrow current-account gap.	Jan.	+ 10%	Nov.	+19%	.00103	-31%	Tighter credit conditions likely.	Indonesia
	Japan	Inventory adjustment making headway; unemployment remains high.	Feb.	-12%	1,142.0	9,707	Mar.	24,189	- 11%	2.3	0	Depressed imports help push first-quarter current surplus to \$3.5 billion.	Apr.	+ 2%	Feb.	+ 2%	.00416	+ 2%	Stronger yen still a prerequisite for monetary easing.	Japan
	Korea	Industrial production picking up in anticipation of export recovery.	Feb.	+ 1%	62.3	1,610	Mar.	2,269	- 20%	1.1	1,228	Jan.-Apr. current-account deficit widened compared to year-earlier period.	Mar.	+ 5%	Jan.	+ 48%	.0013	-13%	Monetary authorities following a more restrictive policy.	Korea
	Malaysia	Recovery hinges on pick-up in external demand.	Nov.	+10%	24.0	1,666	Feb.	3,867	+ 6%	3.7	341	Rubber, tin prices recover strongly; LNG exports to Japan resume.	Dec.	+ 5%	Dec.	+13%	.4347	0	Domestic borrowing restrictions on foreign companies lifted.	Malaysia
	Pakistan	Sixth Plan (fiscal 1983-84 thru 1987-88) will shift government investment to agriculture and energy.	Jan.	- 8%	30.9*	360	Mar.	1,467	+ 79%	3.2	1,321	Western donors pledge \$1.4 billion in aid for 1983-84.	Feb.	+ 5%	Feb.	+21%	.0775	-23%	Rupee stable against U.S. dollar as inflation slows.	Pakistan
	Philippines	World Bank loan of \$302 million supports reforms in trade, energy, and industrial-investment incentives.	Oct.	-10%	38.7	781	Mar.	1,694	- 14%	2.5	1,050	First-quarter current-account deficit narrowed slightly from year earlier.	Dec.	+ 7%	Jan.	+ 5%	.1050	-15%	Ruling reduces bank foreign-exchange holdings.	Philippines
	Singapore	Government spending remains main stimulus.	Jan.	- 5%	12.5	5,121	Dec.	8,480†	+ 12%	3.7	0	Indonesian austerity measures hurt inter-country transactions.	Feb.	0	Dec.	+13%	.4789	+ 1%	Credit conditions easy.	Singapore
	Sri Lanka	Private sector sluggish owing to overvalued rupee, high real interest rates.	Nov.	-11%	4.4	294	Feb.	293	- 3%	1.8	340	Prices rise for traditional export commodities.	Jan.	+ 6%	Dec.	+17%	.0459	- 8%	Interest rates cut, but real rates still high.	Sri Lanka
	Taiwan	Restrictive 1983-84 budget provides no stimulus.	Jan.	+ 2%	46.0	2,559	Feb.	9,420	+ 27%	6.1	0	Import surcharge reduced; export recovery seems to be underway.	Feb.	+ 4%	Feb.	+19%	.0250	- 3%	Stock market booming.	Taiwan
	Thailand	No changes in economic policy anticipated under new government.	Dec.	- 8%	36.1	750	Mar.	1,601	+ 29%	2.2	758	First-quarter trade deficit widened sharply but overall deficit much smaller.	Feb.	+ 3%	Sept.	+11%	.0434	- 6%	High real interest rates depress credit demand.	Thailand
Oceania	Australia	Business cycle expected to bottom out soon.	Jan.	- 3%	158.0	10,632	Mar.	5,615	+240%	2.7	35	Capital flows back in as result of devaluation.	Dec.	+11%	Feb.	+ 1%	.8810	-16%	Interest rates fall following devaluation.	Australia
	New Zealand	Wage-price freeze extended through February 1984.	Feb.	- 3%	23.5*	7,510	Feb.	889	+111%	2.1	0	Current-account deficit almost doubled in 1982.	Dec.	+15%	Jan.	+ 2%	.6609	-13%	M2 growth only 2% in 1982, down from 12% in 1981.	New Zealand
	Papua New Guinea	Rising copper prices will boost slow economy.	Dec.	- 8%	2.5	830	Mar.	301	- 11%	3.0	49	Somare resists calls for another devaluation.	Dec.	+ 7%	Dec.	- 5%	1.1873	-17%	March devaluation expected to push inflation to 10%-11%.	Papua New Guinea

*Fiscal year

†Includes gold holdings

World Interest Rates

market rates as of June 1, 1983; bond yields as of May 27, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.50	10.063 intervention rate	9.50	9.50	4.00*	17.00 penalty rate 20.00	4.50	4.00	5.50
Day-to-Day Money	8.75 June 2	9.25	10.00	8.25	12.50	5.00*	18.00	5.75	3.125 1-month Euro-Swiss fr. rate	6.125
Treasury Bills 91-day, Middle Rates	8.57	9.30	9.875	10.00	n. a.	n. a.	15.952 85 days	no dealing	no market	5.375
Commercial Paper prime, 3-month, asked	8.75 finance paper discount basis	9.40 finance paper 15% tax w/h	9.844	9.40 Certified	9.563 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.75	9.35 15% tax w/h	9.844	9.40 Certified	not traded	5.00*	18.55	no market	4.938	no market
Government Bonds Long-term, new and old issues, average yield	10.85	11.81	10.07	11.325	13.71	7.95†	18.40	8.75	4.47	7.26†
Industrial Bonds prime, long-term, new and old issues, average yield	11.65 Aa Industrials	12.05	12.03	11.645	14.85	8.00†	17.92	8.94	5.87	6.48
Bank Short-Term Rate (prime rate)	10.50	11.00	10.00	14.00	14.55	8.00*	18.75 1/4 qtrly fee on outstg.	7.50	7.50	6.00
Bank Time Deposits 3-month	8.75 Cert. of Dep.	9.35	10.375	9.95	12.563	5.10*	11.50	6.25 large deposits	3.75 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.75	9.813	10.50	no market	13.938	5.563	no market	6.50	5.125	6.75
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8128	1.594	.0197	.1310	.3933	.00067	.3499	.4743	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	0.098 D	0.728 D	0.162 D	4.275 D	4.272 P	6.636 D	3.43 P	4.976 P	3.167 P
Eurodollar Deposits (London, interbank, bid) June 1	7-day 9.125 1-month 9.313 3-month 9.563 6-month 9.813	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills -0.442 U.S.-Canada Treasury Bills -0.297 U.S.-Canada Finance Co. Paper -0.298 Eurodollars-U.K. Local Auth. Deposits +0.166				Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 11.00 Over 7 yrs. 11.00 DM Bonds 7 yrs. and under 7.75 Over 7 yrs. 7.75		Gold Price London afternoon fixing 410.00 (per fine ounce)		

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.
Market rates as of May 25, 1983. † Bond yields as of May 20, 1983.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(Apr.) 3.9	(Apr.) 6.6	(Apr.) 4.0	(Apr.) 9.1	(May) 3.0	(May) 16.4	(Apr.) 4.5	(Mar.) 2.3
Industrial production*	(Apr.) 1.7	(Mar.) -2.6	(Mar.) 1.5	(Mar.) -0.8	(Mar.) -7.9	(Mar.) -9.2	(Dec.) -8.5	(Apr.) 1.5
Trade balance† (billions of local currency units)	(Apr.) -\$4.60	(Mar.) C\$1.39	(Apr.) -£0.36	(Apr.) -FF1.54	(Apr.) DM2.67	(Mar.) -Lit.3,300	(Apr.) -SF0.83	(Mar.) ¥684.7
Money supply (M1)*	(Mar.) 10.9	(Mar.) 10.4	(Mar.) 12.4	(Jan.) 11.5	(Mar.) 10.8	(Dec.) 16.4	(Mar.) 5.8	(Feb.) 6.4
Velocity of money (M1)*	(Mar.) -4.4	(Dec.) 0.3	(Dec.) -1.9**	(Sept.) 0.6**	(Ger.) -3.7	(Sept.) -1.8**	(Mar. '82) 9.3**	(Dec.) 0.8
Reserves minus gold (\$ million, change from previous month)	(Mar.) 29	(Mar.) -363	(Mar.) -390	(Feb.) -2,364	(Mar.) 1,947	(Mar.) -676	(Mar.) 700	(Mar.) 259

* Percent change from 12 months earlier.

** based on GDP

† Figures are only for the month indicated.

Putting Budget Deficits Into Perspective

Not since America's 1980 presidential campaign has the U.S. budget deficit been the focus of so much debate. At the recent economic summit in Williamsburg, Virginia, the nearly \$200 billion in budgetary red ink expected to be tallied by the United States this fiscal year came under attack as a force behind continued high interest rates and a threat to the still-fragile economic recovery. In pre-summit rhetoric, the French were particularly vehement in their criticisms, charging that the huge U.S. deficit resulted in high U.S. interest rates that attracted dollars out of Europe into investment in the United States—raising the value of the dollar on the foreign-exchange markets and keeping persistent downward pressure on the franc.

Some of the fears expressed over the U.S. deficit may prove to be misdirected and somewhat overstated in the long run. Nevertheless, the unusual severity of the past recession, in the aftermath of a long and costly battle with inflation, has prompted policymakers and economists to give greater attention to the way in which one country's deficit affects not only its own domestic economy but the economies of other nations as well.

Cyclical vs. structural deficits

To be sure, the United States is not the only country with budget problems. Public-sector deficits in many other industrial nations are as high or higher as a proportion of GNP (see chart below). But to understand the relative significance of these various shortfalls around the world, it is necessary to put them in economic perspective. The environment in which the deficit occurs has a great deal to do with how each economy is affected. For example, whether the deficit is cyclical or structural in nature, the presence or absence of inflation, and the openness to external trade and capital flows and relative size of the economy in

question all can make a big difference in how interest rates, the mix between investment and consumption, and other economic variables are affected.

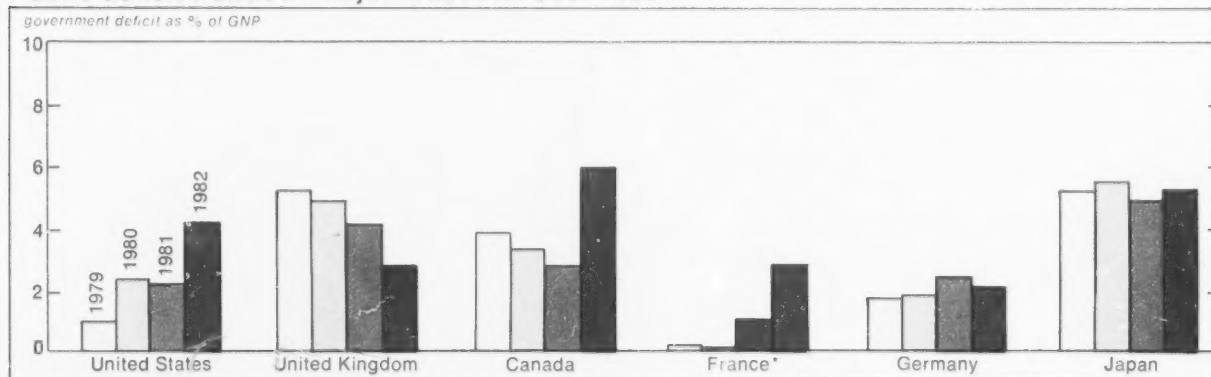
Cyclical deficits arise from shortfalls in government revenue stemming from lower levels of economic activity and from recession-induced government expenditures (mainly transfer payments) to compensate for reductions in private incomes. These deficits are sometimes known as automatic stabilizers because they may support consumer demand during a recession.

Under normal circumstances, cyclical deficits have little net effect on real (inflation-adjusted) interest rates. This is because the rise in government expenditures relative to receipts largely offsets the decline in private-sector investment relative to private-sector saving, which—according to traditional macroeconomic theory—is often the cause of recession. Indeed, in this view, a rise in interest rates coincident with the financing of a cyclical deficit would be counterproductive if the rise deflated the economy further, thereby raising the size of the cyclical deficit to be financed.

Structural deficits, on the other hand—also known as “high-employment” or “full-employment” deficits—abstract from cyclical considerations and measure what the deficit would be if the economy were at or close to its full potential level of output. Often they are interpreted as an indicator of the underlying stance of a country's fiscal policy.

The economic effects of a structural deficit are quite different from those of a cyclical shortfall. To understand why this is so, it is useful to start by taking the case of an economy closed to foreign trade and capital flows and with a stable price level. It is possible to simplify even further by assuming no change in the private sector's willingness to save. Under these conditions, a rise in the government deficit reduces the

Public deficit trends in major industrial countries



*Government deficit as % of GDP

Data: International Monetary Fund and Chase estimates

Putting Budget Deficits Into Perspective (continued from page 7)

economy's aggregate savings, therefore private investment must also fall. The mechanism that brings this about is generally a rise in real interest rates.

The size of these effects—the rise in real interest rates and the fall in private investment—depends on the interest sensitivity of both private savings and investment. The higher the interest sensitivity of private savings, the lower will be the rise in interest rates and the smaller will be the associated fall in private investment. And the higher the interest sensitivity of private investment, the lower the rise in interest rates but the larger the fall in private investment.

While a rise in the structural deficit leads to a fall in *private* investment, this is not necessarily the case for *total* investment. That depends on whether the higher government structural deficit is used to raise *public* investment. If it is, total investment will rise, but by less than the rise in public investment. The size of the effect again depends on the interest sensitivities of private savings and investment. Only if private savings are completely interest-insensitive will there be total "crowding out" of private investment equal to the rise in public investment.

The effects of inflation

The analysis so far has assumed a closed economy with the government's deficit being financed by the issuance of bonds to residents rather than by printing money. If money were printed instead, inflation would sooner or later result.

In the long run, the analysis typically remains valid whether the deficit is monetized or not. Given full employment, monetization should affect only the general price level and *nominal* interest rates, not the competing claims on *real* resources; in other words, relative prices should be unaffected by monetization. However, in the short run, inflation complicates the picture. If savers, investors, and institutions are not set up to anticipate and react to inflation—something that is very unlikely in the long run—unanticipated inflation will act as a tax on savers and a subsidy to investors: The realized real interest rate will fall short of the anticipated one (on which agents base their behavior) by the amount of unanticipated inflation. This accounts for the experience in the late 1970s when real interest rates were even negative for a time. Furthermore, unanticipated inflation is likely to raise the government's real tax take, thus reducing the deficit to be financed. In short, unanticipated inflation acts as a tax to finance the deficit—a tax that begins to disappear once inflation is anticipated.

Even if savers and investors are fully equipped to

react to inflation, a *change in* inflation expectations may well have interim real effects on savings and investment behavior. This happens when a change in inflation expectations affects the real value of financial assets, causing individuals and businesses to adjust their flow of savings until real financial assets again reach their desired level.

Open economies

The analysis changes somewhat if it allows for foreign trade and capital flows. Then the extra savings necessary to finance a government's structural deficit can come from foreigners, allowing private investment at home to be maintained. A particular country as a whole can invest more than it saves, with the difference being a current-account deficit. However, in order to run such a deficit, the country must offer foreigners a higher (risk-adjusted) real rate of return, normally in the form of higher real interest rates. Thus, even in an open economy, a rise in the government's structural deficit implies somewhat higher real interest rates and somewhat lower private investment than in the absence of a deficit. The size of this effect now depends, among other things, on the interest sensitivity of foreign capital flows. Furthermore, in an open economy, there are feedback effects to the rest of the world if the country's structural deficit is large relative to the supply of world savings. By absorbing a major share of world savings, a large structural deficit in a large country will therefore raise the level of real interest rates in the world as a whole.

Interpreted in this light, the concerns expressed by European, Canadian, and Japanese leaders over the structural budget deficits projected for the United States over the next few years appear reasonable. Fears are that a continuation of shortfalls of such a magnitude will not only keep real interest rates from falling, but also lead to a resurgence of rates in the United States and in Europe as well. Furthermore, America is not the only country in the industrial world suffering from a structurally overextended budget. And given the inherent political difficulties in raising taxes or lowering public-sector expenditures, there are growing concerns that these deficits will be financed by a raising of the "inflation tax." These fears are undermining the creditability of the current anti-inflation policies—and helping to hold long-term interest rates at excessively high levels relative to *today's* inflation rates. In the 1970s, financial savers were taxed by underestimating actual inflation rates. Today, they are wary of repeating that mistake.

George de Nemeskeri-Kiss
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The next issue of International Finance will appear on July 18, 1983.

B1900-6/22/83

A Glimmer of Hope For U.S. Exports

U.S. trade data over the next few months are likely to confirm the widely held view that recovery abroad is lagging behind that of the United States. As the American economy gathers steam, imports will surge. The increase in U.S. exports, however, will be considerably smaller, primarily because America's major trading partners—Canada excepted—will grow at a markedly slower rate than the United States over the next few quarters.

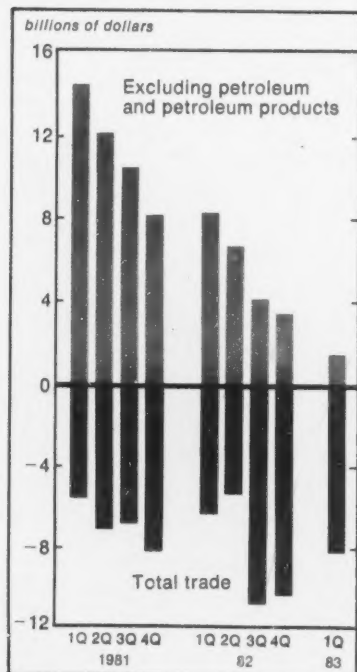
There is general agreement among economists that U.S. net exports are on a declining trend at least until early 1984; however, there is a considerable divergence of opinion over how far they will fall. Many forecasters are calling for a trade deficit in the neighborhood of \$45 billion (census basis) for 1983—\$13 billion more than last year's number. But projections of a somewhat narrower (\$40 billion), or significantly wider (\$50-55 billion), deficit easily can be defended.

While a deterioration in the U.S. trade account is certain to make headlines, the more significant development is that weak export demand will not brake the momentum of the U.S. economy nearly as strongly this year as it did in 1982. Although exports to the OPEC countries are falling, there is a good chance that the trough in demand for U.S. exports by the non-oil developing countries was reached late last year. And with Canadian markets likely to recover significantly, the volume of U.S. exports to the industrialized countries should be somewhat higher by the end of this year than it was at the end of 1982.

The current outlook for a stable-to-slightly-growing level of U.S. exports (adjusted for inflation) is in sharp contrast to the experience of last year, when exports of goods and services fell a staggering 12% (fourth quarter over fourth quarter). The 1982 deterioration is partly explained by the persistent strength of the dollar. However, the timing of the decline suggests that a much more important explanation for the United States' disastrous export performance last year was the abruptly worsened growth of its trading partners in the second half of the year: Debt-service difficulties forced Latin America to cut back imports drastically, and the recession in Canada and Western Europe suddenly intensified.

The strong dollar will continue to hamper U.S. exports and encourage imports. But the primary determinant of the U.S. trade balance will remain the relative economic performance of the United States and its key trading partners.

The U.S. trade balance,* including and excluding oil



*f.a.s. exports, customs imports

*France may be
on verge of recession;
reduction in
trade deficit seen.*

*Norway weathers
oil-price decline
surprisingly well.*

*Mexican private sector
hard hit by country's
financial crisis.*

*China's imports
growing after
surge in capital
spending last year.*

Recently released provisional figures show that France's real GDP in the first quarter expanded at a annual rate of 1.6%. However, this was entirely the result of inventory accumulation, much of which was probably unintended. More recent data show the first effects of the March austerity measures: Industrial orders fell sharply in April and May while stocks rose further, suggesting that the economy is on the verge of a recession. Real GDP for 1983 as a whole is expected to decline by some 0.4%, which would mean an even larger fourth-quarter-to-fourth-quarter decline. This, together with recoveries in the United States and most European countries, would result in a significant improvement in the French trade deficit. The official aim is to halve the deficit to a level of 45 billion francs by May 1984. If Germany's economic recovery gathers steam and the dollar comes off its current highs, France may do even better.

The performance of the Norwegian economy has turned out better than had been expected, given the drop in oil prices. Despite lower oil revenues, the balance of trade has so far shown a larger surplus this year than last. Official figures for the current-account balance show a surplus of 2.2 billion kroner in the first two months of 1983, compared with 1.6 billion in the first two months of 1982. The non-oil sectors of the economy are also showing some strength, so that GDP will remain virtually flat in 1983 after its 1.4% fall in 1982. Inflation, too, is on an improving path. The consumer price index is now rising very slowly, and the year-on-year inflation rate has dropped to 9.1% from 11.3% at the end of last year. Wholesale prices have so far been steady this year, with the most recent year-on-year increase down to 5.7%. Thus, although higher oil prices would have increased the value of Norway's huge oil reserves, the economy is sufficiently diversified to absorb a high degree of fluctuation without undue difficulty.

A major victim of Mexico's financial crisis is the private sector, in large part because of the scarcity of foreign exchange. Private-sector imports will fall again this year—down to approximately \$7 billion from \$9 billion last year and \$15 billion in 1981. In addition, although reactivation of the private sector is one of the announced medium-term goals of the current administration, the government appears to have reduced the priority of servicing the private-sector's foreign debt; some arrears have developed on private-sector interest payments. While current conditions are forcing all sectors of the economy to take belt-tightening measures, to ask the private sector to do more than its share will delay its recovery.

On the strength of an excellent harvest and a significant recovery in heavy industry, China's economic growth rose to an annual rate of 7.4% last year from 3% in 1981. Signs of reflation were most evident in capital construction where the volume of activity grew 25% in 1982 after an 18% slump in the previous year. This increase was due in large part to above-plan expenditures by local governments and individual enterprises, spurred by a relaxation of financial restraint. Only half of 1982's total investment was covered by funds in the state budget; the rest was financed by local budgets and domestic loans. Despite domestic reflation, the Bank of China maintained its strict regulation of convertible currency, and China's imports were unchanged in volume terms in 1982. Continuing growth in export volume—up 6.5%—pushed the trade surplus to \$4.5 billion from \$1.7 billion in 1981. With foreign-exchange reserves in excess of \$11 billion at the end of 1982, China announced that it will repay ahead of schedule the funds borrowed from the IMF two years ago. As a result of the turnaround in capital spending, imports of steel and machinery appear to be on the rise. Thus far, 1983 has shown a clear pickup in Chinese contracts for Western goods. The trade balance is expected to move toward a modest deficit in the second half of the year and early in 1984.

*Modest turnaround
expected for the
Argentine economy.*

Argentina's economy continues to improve, paced by rising agricultural exports and the stimulation of import-substitution output. Real GDP, in the first quarter of 1983 rose almost 1% from its year-earlier level. A rapid rate of currency devaluation and quantitative restrictions have deterred import growth. Consequently, import substitution of goods such as machinery, equipment, paper, and textiles led to an over-5% increase in industrial production in the first quarter. The rising level of activity has been accompanied by high inflation, but monthly price trends have shown a decline, thanks to restrictive monetary and fiscal policies: wholesale prices fell from a 14.7% monthly rate in January to 6.8% in April, and consumer prices dropped from 16% to 10% over the same period. In an important test of the country's stabilization policies, a first-quarter review showed that the government met the IMF's performance criteria. With a foreign trade surplus assured for the year, a continuation of domestic policies aimed at careful reactivation should result in an at least a 3% real GDP rise for 1983. This would be a dramatic improvement from the big output declines of almost 6% per annum in the previous two years.

*Sri Lanka's near-term
outlook improves,
but longer-term
problems loom.*

The immediate prospects for the Sri Lankan economy have improved somewhat, thanks to early elections, government budget measures, the recovery in commodity prices, and the sharp drop in petroleum prices. Real economic growth of somewhat over 5% is expected in 1983, about the same as the 5.1% growth recorded in 1982. In addition, the current-account deficit is expected to narrow to \$450 million—8.5% of GDP—from \$568 million last year, some 11.8% of GDP. Export revenues are projected to increase just over 7% owing to the rebound in prices for Sri Lanka's traditional tree-crop exports, while a sharp drop in the oil import bill will keep import outlays roughly flat. Inflation, however, is expected to accelerate to an average of about 15% in 1983, up from 10.8% last year. Moreover, the Jayewardene government faces a number of longer-term problems—including sluggish tree-crop and manufacturing production, stagnant exports, and excessive reliance on foreign savings—which it must tackle during its second term if the economy is to perform satisfactorily in the future.

*In Turkey,
growth of imports
outpacing exports.*

Foreign trade developments in the first quarter of 1983 have been causing Turkish policymakers some concern. January-March imports showed a provisional year-on-year rise of some 17.6%, while exports grew by only 4.2%. As a result, the trade deficit widened to \$945 million, from \$656 million in the first quarter of 1982. Furthermore, workers remittances—an important source of foreign exchange for the economy—have been running below year-earlier levels in the first two months of 1983. A combination of fairly buoyant domestic demand, reduced exports to the Middle East, and the poor employment picture in Germany appear responsible for this setback. Policymakers are hoping, however, that the upswing in Europe will strengthen and that import growth, which has been erratic on a monthly basis, will abate somewhat.

*Despite shrinking,
reserves, Yemen's
import spending
continues to rise.*

The Yemen Arab Republic, one of the poorest countries in the Middle East, experienced a further deterioration in its external position in 1982 despite an increase in receipts from its major sources of foreign exchange. Remittances from Yemenis working abroad, mainly in Saudi Arabia, grew by 20.9% to \$1.18 billion, while aid grants increased from \$332 million in 1981 to \$439 million. At the same time, however, import spending continued to grow on the back of expansionary fiscal policies, up 13.4% to \$1.965 billion. Also, remittances from foreigners working in Yemen almost doubled to a level of \$362 million. The result was a current-account deficit of \$690 million—some 20% of GNP and \$42 million higher than in 1981. Although the authorities were successful in mobilizing increasing volumes of concessional aid financing, they were unable to prevent reserves from falling by some \$350 million during the year. This decline has continued into 1983. As of April, official reserves totaled \$428 million, the equivalent of 2.6 months of the 1982 import bill.

Corporate Balance Sheets Looking Better

The recovery has brought with it a substantial improvement in business balance sheets. Corporate liquidity is clearly on the rise, and debt/equity ratios are falling for the first time in six years. Both of these developments potentially bode well for the second stage of a typical recovery—the investment boom. However, it may well be premature to look for a large upswing in investment anytime soon.

The fall in debt/equity ratios is one of the more important of the emerging improvements in corporate balance sheets. Since the beginning of the year, gross proceeds from new common stock issues have totaled about \$21 billion, or almost double the total for the first half of 1981. At present, this pace seems likely to continue for at least some weeks to come. And if it holds for the remainder of the year, the proportion of net funds raised from new equity issues to total funds raised externally by nonfinancial corporations will reach a record 35%. This, combined with an almost-certain large jump in retained earnings this year, will provide a boost to stockholders' equity well in excess of the rise in total debt, giving the corporate sector a much-needed infusion of capital.

Corporate liquidity positions are also noticeably healthier. Throughout the last nine months, firms have taken advantage of favorable market conditions to

raise funds in both the stock and the bond markets to pay off short-term debt. Business cash flow has also been bolstered by the drop in corporate tax payments and the surge in corporate tax refunds this year. In fact, 1983 refunds have been running about 75% higher than last year. At the same time, inventories have been run down at a record pace, and firms have made marked additions to their holdings of liquid assets. Since the end of the third quarter of last year, non-financial firms' holdings of liquid assets have gone up by an estimated \$25-30 billion, compared with a rise of only \$5 billion over roughly the same period a year ago. The net result has been a dramatic improvement in the corporate-liquidity measure known as the "quick ratio," or the ratio of liquid assets to current liabilities.

Of course, this improvement does not necessarily mean that corporate balance sheets are in great shape, since they are recovering from recession-battered levels. Still, from a liquidity standpoint, businesses now seem at least able to begin adding to investment—a prerequisite for a sustainable recovery. However, they may not be ready to do so just yet. Factory operating rates are still distressingly low, and there remains widespread concern that the recovery is somewhat fragile. But at least, prospects are looking up.

Thomas A. Lawler

Wage, Productivity Trends Aiding Disinflation

Above-target money growth since last August has raised concerns about a renewed acceleration of inflation. While such concerns may, at a later date, prove to have been justified, the near-term outlook for inflation is quite favorable. Among the forces contributing to that outlook are conditions in the labor market, specifically the prospects for wages, productivity, and unemployment.

Average wage and benefit gains have been slowing for about two years now—from a peak of over 10% in early 1981 to less than 6% currently. Average wage settlements for large collective-bargaining agreements have improved even more dramatically, with the first quarter actually showing compensation *declines* for the first year of multiyear contracts.

High unemployment, of course, has contributed to this moderation. A beneficial side effect of the jobless rate lingering above 10% has been a continuing increase in productivity. Output per man-hour usually rises toward the end of a recession as layoffs cause the decline in the number of hours worked to exceed the drop in output, and the 1981-82 recession was no different. However, the productivity gain of nearly 5% at an annual rate recorded during the first quarter of this recovery is unusually strong—especially in light of the near-zero trend of the past five years.

Higher productivity and lower wage gains combined to sharply reduce the cost of labor per unit of

output, allowing corporate profitability to go up without adding much upward pressure on prices. For example, operating profits surged 60% at an annual rate during the first quarter, while a broad price index rose only 3%; unit labor costs increased only slightly over 1%.

This decline in the relative price of labor has helped to increase labor demand. Payroll employment has risen by more than 1 million since December 1982, enabling the unemployment rate to fall from its peak of 10.8% last November to 10.1% in May.

Although unemployment is edging down, it is still high and will continue to exert some downward pressure on wages. In addition, output gains are likely to continue to outstrip the growth in employment, so rising productivity will keep any unit-labor-cost increase small and allow further gains in profitability without any stepped-up pressure on prices. Moreover, falling unemployment gives the Federal Reserve some more room to rein in rapid money growth.

The only sticking point in the labor-market outlook is the possibility of a rise in the unemployment rate over the summer if the labor force—which has actually been shrinking since December—starts to grow. This might dampen wage gains even more in the short run, but could induce the Fed to continue easing. That would eventually lead to a turnaround in inflation expectations, wage growth, and prices.

Douglas L. Bendt

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GDP IN 1982		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES	
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes			exchange rate in U.S. dollars		change from year earlier		current monetary conditions
												latest data	consumer prices	latest data	money supply(M1)	June 15, 1983			
Argentina	Real GDP increased by almost 1% in first quarter, led by industry and agriculture.	Dec.	-37%	130.0	4,594	Feb.	3,859	+ 11%	9.3	888	IMF targets met in March.	Mar.	+304%	Nov.	+242%	.1052*	-85%	New Argentine peso denominated.	Argentina
Brazil	Increases in taxes, cuts in subsidies and spending form part of renewed austerity plan.	Dec.	-17%	293.0	2,382	Dec.	3,928	- 41%	2.3	1,449	IMF targets missed in March.	Feb.	+106%	Dec.	+ 72%	.00215	-69%	Attempt made to lower interest rates.	Brazil
Chile	Economic activity continues to deteriorate.	Jan.	- 8%	23.7	2,060	Apr.	1,225	- 56%	5.1	451	Current account posted \$120-billion surplus in first quarter.	Mar.	+ 25%	Nov.	- 8%	.0136	-45%	Nominal interest rates declining.	Chile
Colombia	Real activity adversely affected by decline of domestic and foreign markets.	Oct.	+ 9%	39.0	1,423	Apr.	2,980	- 31%	6.4	0	Reserves have declined \$827 million since end-1982.	Mar.	+ 22%	June	+ 24%	.0131	-22%	Bank legal lending limits proposed.	Colombia
Costa Rica	Confidence increasing in government's economic policy.	Feb.	-14%	2.8	1,164	Apr.	284	+ 97%	4.0	105	Higher prices on agricultural exports will help trade balances.	Dec.	+ 82%	Nov.'81	+ 70%	.0290	+ 5%	Credit still restricted.	Costa Rica
Dominican Rep.	Growth to be constrained by IMF-supported austerity program and lack of private investment.	Nov.	-37%	8.2	1,464	Apr.	173	- 7%	1.3	194	Falconbridge expects to produce half of last year's mineral output.	Oct.	+ 8%	Jan.	+ 8%	Par	-	Liquidity is tight.	Dominican Rep.
Ecuador	Slowdown in economy prompted by stabilization program and weather problems.	Nov.	-20%	14.0	1,573	Apr.	244	- 61%	1.7	0	Oil export earnings offset non-oil export decline.	Feb.	+ 29%	Oct.	- 21%	.0124	-54%	Monetary policy is restrictive.	Ecuador
El Salvador	Economy deteriorating because of civil war.	Dec.	-23%	3.6	729	Apr.	100	+ 4%	1.3	105	Destructive war reducing export output.	Jan.	+ 13%	Jan.	0	.4000	0	Credit policy loose to reactivate economy.	El Salvador
Guatemala	Private sector confused by president's attitude.	Jan.	+22%	8.4	1,090	Apr.	65	- 66%	0.6	103	Improvements in sugar and small oil exports.	Feb.	- 1%	Feb.	- 6%	Par	-	Credit restricted to build up reserves.	Guatemala
Honduras	Political turmoil leading to reductions in private investment.	Oct.	-22%	2.8	718	Apr.	113	+ 8%	2.1	118	Better prices but low volume of agricultural exports expected.	Dec.	+ 10%	Nov.	+ 3%	.5000	0	IMF's tight credit guidelines still being followed.	Honduras
Jamaica	March IMF performance targets were not met.	Dec.	-27%	3.1	1,378	Mar.	96	- 29%	0.8	599	United States will double purchases of Jamaican bauxite this year.	Dec.	+ 7%	Feb.	+ 6%	.5600	- 2%	Credit policy is restrictive.	Jamaica
Mexico	Government complying fully with IMF stabilization program.	Jan.	+27%	207.0	2,248	Sept.	1,153	- 59%	1.7	326	Large trade surplus recorded in first quarter.	Mar.	+115%	Dec.	+ 66%	.00664	-68%	Domestic credit policy is tight.	Mexico
Nicaragua	Another debt rescheduling sought for both interest and principal.	Aug. '81	+27%	2.7	930	Nov. '79	85	+ 42%	1.1	19	Exports affected by guerrilla war.	July '81	+ 28%	Dec.	+ 26%	.1000	+ 1%	Domestic credit increasing rapidly.	Nicaragua
Panama	Government fiscal program is more restrictive to cut borrowing needs.	Dec.	+64%	4.0	2,020	Mar.	64	- 42%	0.5	81	New IMF program being approved.	Feb.	+ 2%	Dec.	+ 5%	Par	-	Credit growth is moderate.	Panama
Paraguay	Floods interfering with normal import-export activity.	Feb.	-41%	5.7	1,691	Apr.	696	- 13%	12.0	0	Lower capital inflows depress reserves.	Dec.	+ 4%	Aug.	- 4%	.00625	-21%	Money growth shows sharp decline.	Paraguay
Peru	Price of petroleum (currently \$1.10 per gallon) being raised to maintain present dollar price.	Dec.	+ 1%	19.8	1,053	Jan.	1,156	0	4.1	612	Liquid reserves fell to \$550 million at end-March from \$1 billion end-1982.	Feb.	+ 85%	Dec.	+ 35%	.00069	-55%	Net foreign assets declining.	Peru
Uruguay	Industrial production declined 17% in 1982.	Dec.	- 5%	9.4	3,240	Feb.	58	- 76%	0.8	82	Oil imports down sharply: Feb. total was \$48mn. vs. \$103mn. year earlier.	Jan.	+ 38%	Dec.	+ 20%	.0103	-88%	Credit expansion restricted.	Uruguay
Venezuela	Import shortages and payments delays depress business activity.	Dec.	- 1%	73.0	4,666	Apr.	5,559	- 25%	5.4	0	IMF export-shortfall facility being sought.	Feb.	+ 6%	Jan.	+ 7%	.0980	-58%	Discount rate cut to stimulate credit.	Venezuela

*In terms of new Argentine peso

World Interest Rates

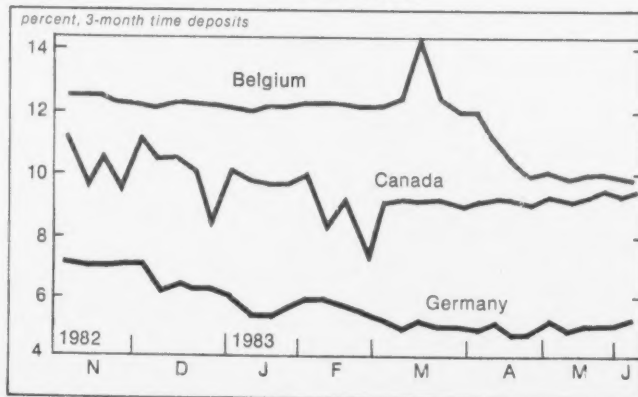
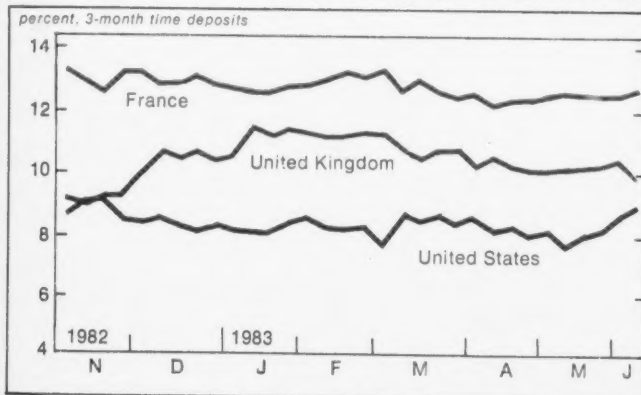
market rates as of June 15, 1983; bond yields as of June 10, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.53	n. a. intervention rate	9.50	9.50	4.00	17.00 penalty rate 20 GO	4.50	4.00	5.50
Day-to-Day Money	9.00 June 16	9.00	9.50	9.50	12.375	5.00	17.75	5.25	3.375 1-month Euro-Swiss fr. rate	6.25
Treasury Bills 91-day, Middle Rates	8.70	9.22	9.438	9.75	n. a.	n. a.	15.899 71 days	no dealing	no market	5.375
Commercial Paper prime, 3-month, asked	9.125 finance paper discount basis	9.30 finance paper 15% tax w/h	n. a.	9.40 Certified	12.688 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	9.10	9.25 15% tax w/h	9.359	9.40 Certified	not traded	5.00	18.55	no market	5.25	no market
Government Bonds Long-term, new and old issues, average yield	11.03	11.70	n. a.	10.19	13.65	8.02	18.36	9.40	4.57	7.231
Industrial Bonds prime, long-term, new and old issues, average yield	11.75 As Industrials	12.20	n. a.	11.82	14.80	8.02	17.95	9.36	5.90	6.47
Bank Short-Term Rate (prime rate)	10.50	11.50	10.00	13.25	14.55	8.00	18.75 ¼ atry fee on outstg.	8.00	7.50	6.00
Bank Time Deposits 3-month	9.10 Cert. of Dep.	9.30	9.75	9.65	12.75	5.55	11.50	6.125 large deposits	4.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.8125	9.563	9.875	no market	14.875	5.375	no market	5.813	5.188	6.50
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8089	1.513	.0195	.1292	.3884	.0007	.3468	.4670	.0041
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	0.198 P	0.079 D	0.123 D	5.263 D	4.428 P	7.927 D	3.922 P	4.882 P	3.311 P

Eurodollar Deposits (London, interbank, bid) June 16 7-day 9.25 1-month 9.438 3-month 9.625 6-month 9.938	International Arbitrage (3-month, hedged) + in favor of U.S. dollars U.S.-U.K. Treasury Bills -0.530 U.S.-Canada Treasury Bills -0.387 U.S.-Canada Finance Co. Paper -0.246 Eurodollars-U.K. Local Auth. Deposits +0.079	Eurobonds (average yield on recent straight debt issues) U.S. Dollar Bonds 7 yrs. and under 11.25 Over 7 yrs. 11.50 DM Bonds 7 yrs. and under 7.50 Over 7 yrs. 7.75	Gold Price London afternoon fixing 408.25 (per fine ounce)
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.

Interest-rate movements in selected industrial countries



Smaller Surpluses, but No Deficits, for Kuwait

Soft world oil markets and the resulting sharp drop in oil revenues have greatly reduced Kuwait's budget and current-account surpluses during the last three years. But thanks to ample income from the government's foreign investments neither will move into deficit.

The draft budget for fiscal 1983-84, which begins July 1, was announced in late April. Contrary to the government's forecasts, however, it is not likely to show a deficit. The budget is designed to offset both the adverse effects on private-sector activity of last year's stock-market crisis and the slowdown in state outlays prescribed by fiscal 1982-83's "austerity budget." Expenditures are projected to rise 12% over the current budget to 3.55 billion Kuwaiti dinars (KD). Although new charges will be levied on some public services and subsidies cut on others, the authorities have apparently decided not to introduce income taxes. And with continued weakness expected in the world oil markets, state revenues are expected to fall to KD3.04 billion—a 5% decline from the level projected for fiscal 1982-83. According to the government's estimates, this would push the budget into the red by some KD517 million (\$1.8 billion), not counting the standard allocations to Kuwait's Reserve Fund for Future Generations and to the Kuwait Fund for Arab Economic Development.

The government's projections of state revenues are based primarily on its forecast of Kuwaiti oil production, since the petroleum sector has generated the bulk of government receipts for more than a decade (64% in fiscal 1981-82). Crude-oil production in 1982 averaged 828,000 barrels per day (including its share of Neutral Zone output)—a 27% drop from its 1981 level and less than half the quantity produced in 1980. At its March meeting, OPEC assigned Kuwait a production ceiling of 1.05 million b/d. But given the outlook for world demand for OPEC oil, the country's oil output in 1983—which in the first quarter averaged 878,000 b/d—is expected to fall short of that quota.

As far as the oil-sector forecast goes, the draft budget's estimates of government revenues appear to be realistic. The problem with the budget lies in its estimates of investment income. Official forecasts have consistently understated non-oil revenues, primarily income from government holdings of real and financial foreign assets. If the government again earns as much as KD1.4 billion from its investments, the realized 1983-84 budget will show a surplus of about KD800 million—assuming that actual government outlays approximate the level projected.

Historically, Kuwait's actual government expenditures have tended to fall short of budget projections,

except in fiscal 1981-82 when outlays slightly exceeded the estimates. However, there are reasons to think expenditures in fiscal year 1983-84—as well as those in the current fiscal 1982-83—will match levels projected by the government.

For one thing, Kuwait's oil output declines have not only severely cut back oil revenues, they have raised other costs as well. With the drop in oil production, associated flows of natural gas liquids—used to fuel electric-power and desalination plants—have fallen, forcing stepped-up usage of more expensive gas oil. It may well be that extra outlays on domestic fuel requirements will offset the government's traditional tendency to underspend.

In addition, the government is likely to be more liberal with its spending as part of its efforts to offset the impact on the private sector of the turmoil in the Souk al-Manakh stock market. Measures taken by the government during the last several months appear to have successfully contained this crisis.

In the absence of any further sharp drop in OPEC's official price for oil, the other main impact on Kuwait of the soft oil market conditions, which are likely to persist over the near term, will be a continued contraction in its current-account surpluses from just under \$6 billion this year to slightly over \$4.5 billion in 1985. However, Kuwait's current account would have moved into deficit beginning in 1982 had it not been for the government's investment income.

Foreign investments intact

Additions to Kuwait's stock of foreign assets, through at least 1985, will be substantially smaller than they have been in the past, since it seems likely that the authorities will be forced to make use of some foreign investment income to cover a portion of budget outlays over the next two to three years. It is unlikely, however, that the stock of foreign assets will need to be drawn down. Public-sector assets, held mainly by the government, totaled some \$72 billion as of the end of 1982. And because the bulk of these are invested internationally, in both financial and real holdings that are providing a still-sizable and diversified income stream, the state of Kuwait remains quite strong financially. Moreover, the country can be expected to continue to register annual financial surpluses, especially after 1985. At that time, demand for OPEC oil is expected to pickup somewhat, a larger proportion of the country's oil exports will be in the form of refined products shipped on Kuwaiti carriers, and state expenditures are projected to level off as major projects are completed.

Sharif Ghalib

Spain Moving to Curb Deficits, Inflation

Despite initial uncertainties about the direction of Spain's economic policy under the Socialists, the government's actions during almost seven months in office speak louder than its pre-election rhetoric. Although 1982 ended another year of lackluster growth, bringing strong pressures for reflation, the new government thus far has avoided expansionary policies and appears to be focusing on curbing inflation and getting fiscal deficits and external indebtedness under control before tackling the unemployment problem.

The proposed budget for 1983, which was presented to the Cortes in April, calls for a central-government deficit of 1.1 trillion pesetas. While this is up from 1982's deficit of 996 billion pesetas, it is significantly lower than the 1.35-trillion-peseta shortfall forecast for 1983 earlier in the year, and if achieved, it would hold the deficit at 5% of GDP. The budget plan includes a rise in the overall tax burden of about 1%, with the maximum rate of income tax raised to 45% from 43%. Ministerial spending and the social-security budget have been cut back, although investment spending is budgeted to rise by 10% in real terms in order to stimulate productive employment.

The budget proposal for 1983 stops short of the financial stabilization program Spain needs. However, it does provide a basis for hope that the problem of fiscal deterioration is finally being addressed. Because final approval of the budget will probably be delayed until late July, spending in the first half of the year has already been somewhat restricted. Nonetheless, a budget overrun is still a strong possibility, and a large volume of non-budgetary public-sector obligations remains to be financed.

The government's monetary actions over the past several months suggest that monetary policy has been aimed at stabilization. The economic program outlined by the Socialists prior to the election specifically stated that strict adherence to money-growth targets would not be a principal strategy. However, recent developments indicate an extremely restrictive monetary stance. In December, the year-on-year growth rate for M3 was 16.1%. Given that the government has called for 2% real GDP growth in 1983 and a reduction in the inflation rate to 12%, the announced target for M3 of 13% must be considered ambitious and restrictive. Nevertheless, the authorities seem to be making a concerted effort to achieve it. At the end of last year, banks' reserve requirements were raised to 6.75% from 5.75%, and in April, compulsory deposits at the Bank of Spain were increased by one percentage point. By April, year-on-year M3 growth was down to 14.5%, and over the last two months interbank interest rates have exceeded 20%.

Despite such monetary restrictiveness, however, the government's inflation target looks optimistic. Spain's

inflation problem has proved to be intractable. The average inflation rate for last year was 14.4%—the same as in 1981 and only a marginal improvement over 1979's 15.7%. Unfortunately, last December's 8% devaluation of the peseta has made the inflation battle all the more difficult. Although prior to the election, the Socialists had viewed the currency move as a means to improve Spain's export competitiveness, there are doubts whether the action was necessary. Spain's export performance in 1982 proved surprisingly strong, indicating that its exports were competitive even before the devaluation. Furthermore, unless wage pressures can be controlled, any short-term benefits from the devaluation will soon be dissipated.

The government's labor policies and recent labor-market developments, however, are likely to have hampered any wage downtrend. The government did fulfill its campaign promise to reduce the work week to 40 hours from 42 hours and increased the statutory minimum vacation to 30 days per year. In addition, the national minimum wage was raised by 13% in January. In the same month, the trade unions and the employers' federation reached agreement on a band of 9.5% to 12.5% for salary increases during 1983. All of these developments can be expected to increase real wage costs this year but, unfortunately, will do nothing to alleviate Spain's continuing rise in unemployment. As of May, joblessness had risen to 2.13 million, 16.3% of the active population.

Prospects for recovery

The Spanish government apparently has realistically accepted that this year will bring only a weak recovery. The budget offers only modest stimulation, and the tight monetary policy will constrain any rebound. The external sector can be expected to provide only a small boost, in that the impact of the global recovery is likely to be meager in 1983. The economy of France—Spain's major market—is contracting, and exports to the OPEC countries, which were an important source of growth in 1982, are unlikely to be sustained. However, as long as wages remain in check, the depreciated peseta should ensure that Spanish exports and tourist facilities are highly competitive. Meanwhile, the fall in the price of oil will save Spain more than \$1.5 billion and help to improve industrial profitability, although the weakened peseta will limit these gains.

On balance, the government's forecast of 2% real growth looks somewhat optimistic, but its projection of a narrowing of the current-account deficit to \$2.5 billion appears realistic. Expectations of better economic performance in 1984-85 seem justified, although the recovery may not be strong enough to have much impact on Spain's growing pool of unemployed.

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Vol. XVIII, No. 14
July 18, 1983

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

U.S. Monetary Policy: Too Loose or Too Tight?

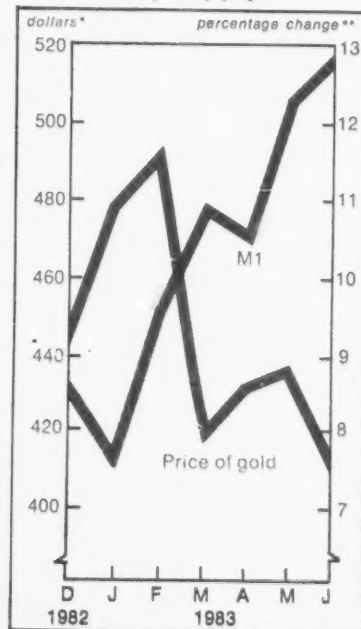
The difficulties of managing U.S. monetary policy have been intensified by conflicting indicators of the current thrust of policy actions and by conflicting approaches being used to interpret these indicators. From the traditional perspective that treats the United States as a "closed" economy—largely insulated from economic trends abroad—U.S. monetary policy is clearly too loose. But from an opposite perspective that regards the U.S. economy as "open"—unable to insulate itself from foreign influences—policy is too tight. The question of which perspective to employ is critical. An erroneous interpretation of the signals by the Federal Reserve in one direction could lead it to take actions that would reaccelerate inflation. And an error in the other direction could induce a move that would jeopardize the fragile economic recovery and the stability of the international financial system.

Economists who employ the closed-economy perspective point out that the narrowly defined money supply, M1, has grown at a double-digit pace over the past 12 months—far above its target range. They argue that the money stock cannot continue to expand at this rate for much longer without igniting another inflationary explosion. The open-economy school notes, however, that international price indicators suggest that U.S. monetary policy is relatively tight. The dollar is strong against all major currencies, while the prices of precious metals remain relatively low.

This conflict between domestic and international indicators of U.S. monetary policy is a recent development. During the fixed-exchange-rate period of the 1950s and 1960s, the signals emitted at home and abroad were generally consistent. And even after the advent of floating exchange rates in the 1970s, indicators used by "closed-economy" and "open-economy" Fed-watchers ordinarily moved together. Rapid money growth was usually accompanied by a weakening dollar and rising prices of precious metals. But today—at least on a week-to-week basis—above-target money growth typically leads to a strengthening, not a weakening, of the dollar, as the market reacts in anticipation of a tightening move by the Fed.

Clearly, if the international "price" indicators are right about U.S. monetary policy, then the domestic "quantity" signals are wrong—and vice versa. Since it is not possible to know which are correct, the important issue for policy is precisely that the indicators are yielding mixed signals. The Fed must therefore tread adroitly along a narrow path to avoid plunging off either side of the cliff.

**Precious metals prices
and the growth of the
U.S. money supply**



*monthly average of daily price per fine ounce
**year over year

*Thatcher victory
fails to resolve
Britain's economic
policy dilemmas.*

*Weak export demand
causing German recovery
to lose steam.*

*Greek economic indicators
suggest drachma
still overvalued.*

*Australian budget
prospects
brighter.*

At first glance, the recent statistics on the British economy and the huge majority won in last month's election suggest Mrs. Thatcher's government is in an exceptionally strong position. Banks' base rates have been cut by 50 basis points, the inflation rate has dropped to a year-on-year 3.7%, and domestic production is at last responding to the recent large increases in demand. However, the government still faces serious problems in both the short and the long run. The money supply has been growing at an annualized rate of some 16% since February—compared with a target maximum of 11%—and the budget deficit is running at higher-than-expected levels. The bond market is now looking for a rise in interest rates. Without one, the government will be forced to monetize more of its deficit and further swell the money supply; with one, however, the government risks choking off the long-awaited recovery. Furthermore, forecasts currently circulating within the Treasury indicate that, despite Mrs. Thatcher's efforts, public-sector costs will continue to go up over the next few years. Unless the economy grows relatively quickly and so boosts the government's tax base, tax rates will have to be hiked to avoid a widening of the deficit. This would move the government further away from one of its crucial long-term objectives.

The latest data on the German economy suggest that the recovery, which set in during first months of 1983, is faltering. Industrial production remained provisionally unchanged in May from April's downward revised figure. This level is some 0.5% higher than in January and February. But a similar two-month comparison for industrial-order volume shows a 0.5% decline. Weakness was concentrated in the export sector: Foreign-order volume dropped 2.5% while domestic orders advanced 1%. The outlook for exports for the remainder of 1983 is relatively gloomy. France—Germany's largest trading partner—is taking steps to reduce demand, and Italy remains in recession. Meanwhile Eastern Europe, OPEC, and the non-oil LDC's are not likely to raise their orders for German exports. Domestic demand in Germany, however, should continue to strengthen—albeit at a slower pace than early in the year—as the construction industry remains robust and as consumers' incomes rise again toward year-end. Nonetheless, the recovery overall is expected to be quite weak relative to past recoveries.

The Greek economy remains in a difficult position. Industrial production in the first quarter showed a 2.5% drop from its year-earlier level and shows no signs of picking up. But the balance of payments is deteriorating. Provisional data for the first five months of 1983 show a current-account deficit of \$1.08 billion, compared with a \$938-million shortfall in the year-earlier period. While the trade deficit declined—both exports and imports fell—the surplus on invisible items such as tourism, shipping, and workers' remittances declined even more. Meanwhile inflation remains high, showing a year-on-year advance of over 22% in May. These figures suggest that, despite the devaluation in early 1983, the drachma remains overvalued against European trading partners. This position can only be remedied by either a further downward adjustment of the drachma or a reduction in inflation relative to that prevailing in the rest of Europe.

One of Australian Prime Minister Hawke's principal policy objectives—to lower the projected government budget deficit for fiscal 1983-84—is getting a boost from an improvement in the outlook for economic growth. In hopes that a smaller deficit would help engineer a permanent reduction in interest rates, the new Hawke government, at its economic summit in April, set a goal to slash the deficit to A\$8.5 billion from the A\$9.6 billion projected by the outgoing Prime Minister Fraser. The Fraser projection was based on a conservative expected real growth estimate of only 1.5% for Australia's non-farm sector. Real growth prospects now, however, look much better—at least 2.5% seems likely. Consequently, the deficit will shrink without any government actions to cut spending or increase taxes. At present, the initial Hawke target looks easy to attain. And Mr. Hawke might be tempted to try for an even lower deficit.

Venezuelan current-account deficit may narrow despite likely fall in oil revenues.

Although Venezuela's average export volume for petroleum is running at about its 1982 rate, lower prices this year will mean a substantial drop in total oil earnings. In the first five months of this year, oil-export volume has been averaging 1.5 million barrels per day (mbd), with the average price slightly below \$25 per barrel. For all of 1982, the average export price was about \$27.50 per barrel, with an average export volume of 1.56 mbd. The expectation is that, for the year as a whole, 1983 export prices will average around \$24.50 and volume will trend out at a little under 1.5 mbd. As a result, oil revenues are expected to drop to about \$13.2 billion this year from \$15.6 billion in 1982. This shortfall in export earnings, however, is likely to be more than offset by a large policy-imposed cut in imports. Consequently, the overall current-account position could show a deficit smaller than last year's \$3.5 billion.

Jamaica posts still-sluggish growth and a current-account deficit.

The Jamaican economy remains in a somewhat precarious position. The government budget deficit has risen to the equivalent of 16% of GDP and the money supply (M2)—fueled by domestic credit expansion to the public sector—has been growing at a rate of about 26% for the past year. Despite the expansive thrust of demand-management policies, however, real GDP is estimated to have posted a mere 2% gain in fiscal 1982-83, only modestly more than the previous year's 1.2% rise. Furthermore, performance in the different sectors of the economy has varied widely. Inflation, meanwhile, increased slightly to just under 7%, as imports continued to provide a vent for excess aggregate demand, at least until January when a dual exchange-rate system was enacted. However, Jamaica's overall balance of payments underwent a substantial deterioration, swinging into a \$146-million deficit from a \$43-million surplus in fiscal 1981-82.

Japanese government looking for ways to reverse import decline.

Japan's continued weak domestic demand and the resultant higher-than-expected current-account surplus are causing government concern over a possible resurgence of trade frictions. The first quarter's 0.8% increase in GNP (seasonally adjusted, annual rate) was primarily the result of stepped-up government consumption spending and a sharp drop in imports. Private-sector domestic demand actually fell, with declines in housing and plant-and-equipment investment as well as a steep rundown of inventories. With imports consequently depressed, the seasonally-adjusted current-account surplus topped \$8.1 billion in the first five months of 1983, already surpassing the \$6.9 billion surplus recorded for all of 1982. The fear that trade tensions will be reignited has created pressure for steps to boost domestic demand and imports. But the Bank of Japan remains adamantly opposed to any cut in domestic interest rates before the yen advances on the foreign-exchange markets. In addition, because of Japan's continued budget deficit problem, any fiscal stimulus, even an income tax cut, will be difficult. Pressed nonetheless to take some action, the government is reportedly studying new incentives and additional regulatory changes to bolster imports.

Madagascar grapples with external debt difficulties.

Madagascar continues to face severe balance-of-payments problems. Further arrears have been accumulated on its over \$1.5-billion debt, despite reschedulings and other international aid. A one-year, \$55-million IMF standby agreement went into effect in early July 1982. The government succeeded in meeting conditions of the agreement until last month, when its final drawing was cancelled because of arrears that resulted from a shortfall in export receipts. Cloves—Madagascar's second largest foreign-exchange earner—normally bring in 25% of export receipts, primarily from Indonesia. However, during price renegotiations between the two countries, the clove trade ceased. Exports reportedly have now resumed, and the IMF is discussing terms for a new standby agreement. The country rescheduled its foreign commercial-bank debt through the London Club in January and its foreign official debt through the Paris Club in April. Drawings on a \$54-million structural-adjustment loan, which the World Bank agreed to in May, are now awaiting the bank's appraisal of economic conditions.

The Consumer Finally Comes on Strong

Despite a slow start, consumers now seem quite willing to lead the economy into a boom. Although retail sales increased only 0.7% in June, the three previous months showed gains that averaged over 2%. This strength—along with a faster pace of housing construction—is more than offsetting continuing weaknesses in other sectors. Although the recent rise in interest rates and the possibility of further increases are causing some concern about the strength and sustainability of the recovery, consumer spending is likely to be robust enough to keep the economy expanding for a while.

Even with the spring spurt in sales, personal consumption expenditures are still lagging behind the pace of the two previous recoveries. Retail sales, adjusted for inflation, have increased just under 5% since the recession's trough in November, compared with gains of 7% and 6%, respectively in the first seven months following the 1969-70 and 1973-75 recessions.

One reason consumers got off to a slower start this time around was the unusually sharp inventory liquidation over the winter. With inventory financing costs remaining high, businesses were content to meet the stepped-up demand initially by reducing stocks, which kept a damper on production and employment, and hence on income. Eventually inventories got so low, however, that increases in demand in the past few months have been filled by expanding production,

which has added a further boost to employment and income. In fact, production gains have outpaced sales, and as a result, inventories have actually been rising recently.

Retail sales have also received a lift from consumers' greater willingness to borrow as the employment picture has brightened. In the last six months, consumer credit outstanding grew at an 8% annual rate, while income rose only 6%. In the previous six-month period, income advanced almost as rapidly, but credit use grew by less than 3%.

The third installment of personal income-tax reductions, which took place on July 1, is another force lending at least moderate support to the consumer expansion. After-tax income in July will jump by nearly 2%—double recent monthly increases. Usually, such a robust gain would be expected to lead to sharp sales increases in subsequent months. But the spring spending spree may somewhat moderate further gains as consumers rebuild their savings a bit, especially with interest rates edging upward.

On balance, however, the odds are that this process—higher sales followed by higher production, employment, and income—will become self-sustaining. In other words, this expansion should prove to be a normal recovery. It would take quite a shock—more than seems probable in the near term—to change this outlook.

Douglas L. Bendt

The High Cost of Restraining M1

Federal Reserve officials continue to insist that the behavior of M1 is of limited concern in monetary policy decisions. And over the past several months, it has become increasingly evident that the Fed has been more concerned with stabilizing interest rates than with containing the growth of the money supply. The consensus among most economists and money-market analysts, however, is that the Fed will soon have to take steps to rein in M1 growth—still far above target for the year—in order to head off a rekindling of inflation expectations. But when Fed officials do begin to move in this direction—assuming they have not already done so—they are likely to find that, because of institutional changes in the last few years, it will take a much sharper rise in interest rates than previous experience would suggest to get M1 growth back into the desired range.

In past years, the Fed could rely on a relatively small rise in interest rates to effect a reduction in the growth of M1. A hike in rates would curb the demand for credit and money: Borrowing would diminish, and with the increasing opportunity cost of keeping balances in non-interest bearing demand deposits, funds would be shifted into less-liquid, interest-bearing instruments not included in M1.

Recent institutional changes, however, have made M1 less responsive to movements in interest rates. The introduction of Super-NOW accounts early this

year and the inclusion of these accounts in the Fed's definition of M1, have altered the way in which individuals are likely to react to a rise in rates. An increase in rates is now more likely than before to elicit an intra-M1 shift in individual portfolios. As a consequence, the Fed will find that, compared with its experience before these changes came about, a much larger rise in interest rates will be required to achieve a particular deceleration of M1 growth.

Credit demand, however, is still likely to be sensitive to a rate increase. And a substantial rise in interest rates could have a strong negative effect on real economic activity.

The Fed's focus on interest rates has, in any event, reduced uncertainty over the future course of money-market interest rates. One clear piece of evidence of this is the drop-off in interest-rate hedging activity. Contract volume in Treasury-bill futures has fallen to about one-half of the peak volume reached in mid-1982, reflecting the market's judgment that the Fed would allow rates to fluctuate only over a narrow range.

Interest-rate targeting, however, does not mean that the targets will not change. And if the Fed wants to avoid a resurgence of inflation expectations—and another painful episode of bringing them under control—it may soon be forced to allow rates to rise significantly in order to subdue the rapid growth of the money stock.

Dan C. Roberts

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF PAYMENTS					MONEY AND BANKING							COUNTRIES	
		6 months ending	change from year earlier	in billions of dollars	\$ per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes		exchange rate in U.S. dollars July 13, 1983	change from year earlier	current monetary conditions			
												latest data	consumer prices				latest data		money supply(M1)
Algeria	Government reportedly has decided to double capacity of gas pipeline to Italy.	Dec. '81	-14%	36.0*	1,935	May	1,649	-45%	0.7	0	Oil output avgd. 651,000 b/d Jan.-April, almost same as year earlier.	Dec. '81	+ 7%	Sept.	+ 24%	.2116	- 7%	Sonatrach Euroloan for \$700 million signed June 3.	Algeria
Angola	Military and agricultural expenditures and export decline have caused short-term debt build-up.	Dec.	- 7%	n.a.	n.a.	Dec.	122	+ 6%	1.0	0	Oil export prices no longer pegged to OPEC, discounts offered.	Dec.	+15%	n.a.	n.a.	.0330	0	Inflation continues to increase yearly, now reaching 15%.	Angola
Egypt	World Bank to lend \$400 million in fiscal 1983-84 for development projects.	Jan.	+15%	30.8	710	Mar.	751	- 2%	0.7	53	Crude-oil prices raised by 25¢-50¢ per barrel starting July 1.	Jan.	+15%	Mar.	+ 27%	1.2092	+ 1%	Central bank foreign-exchange reserves holding steady.	Egypt
Kenya	Good crop outlook and rising commodity prices should improve GDP and export earnings.	Nov.	-14%	6.6	383	May	325	+95%	2.8	391	Trade balance has improved; IMF and official aid promised.	Feb.	+14%	Mar.	+11%	.0800	-27%	International reserves have doubled since autumn 1982.	Kenya
Malawi	Smallholder crops expected to increase in volume.	Dec.	- 4%	1.4**	219	May	30	-36%	1.1	100	Larger tobacco and tea output should improve trade balance.	Feb.	+20%	Apr.	+ 6%	.8949	- 1%	Gov. borrowing from banking system to fund deficits.	Malawi
Morocco	Grain crop estimated down 30% to 3.2 million tons owing to poor rainfall.	Feb.	-13%	15.2	735	Apr.	67	-87%	0.2	922	Income from tourism rose 16% last year to \$380 million.	Feb.	+ 4%	Nov.	+14%	.1460	-23%	Islamic Development Bank lends \$20 million.	Morocco
Niger	Uranium output projected to drop 14% in 1983 in response to world oversupply.	Dec. '81	-10%	1.6	281	Mar.	22	-75%	0.4	0	Government austerity budget implemented preceding IMF aid negotiations.	Mar.	- 3%	Dec.	- 5%	.00262	-21%	Foreign-exchange reserves down to one-tenth 1981 holdings.	Niger
Nigeria	Oil production exceeding OPEC daily quota by 400,000 b/d, offsetting low early-1983 levels.	Apr.	-27%	70.8	888	May	1,218	0	0.7	0	Debt rescheduling and IMF aid under negotiation.	Sept.	+ 4%	Dec.	+ 5%	1.4751	0	Exchange-rate adjustments likely after August elections.	Nigeria
Senegal	Good weather suggests quadrupling of groundnut harvest over 1980-81; low of 192,000 tons.	Dec. '81	-19%	2.5	439	Mar.	4	-33%	0.1	174	Groundnut harvest boosting export revenues; imports being held down.	Feb.	+ 9%	Jan.	+14%	.00262	-10%	Inflation rate has slowed to 9% from 1982's 16%.	Senegal
South Africa	Gold prices and severe drought should cause real GDP to decline 2% in 1983.	Apr.	+ 8%	70.2**	2,330	May	436	-13%	0.4	857	Imports projected to fall 13% below 1982 owing to reduced economic activity.	Apr.	+13%	Mar.	+13%	.9125	+ 5%	Foreign-exchange controls being relaxed gradually.	South Africa
Sudan	Government expenditure emphasizing completion or rehabilitation of existing projects.	Dec.	+14%	6.7	356	May	16	-25%	0.1	586	Exports reduced by partial loss of Saudi import subsidies.	Mar. '82	+15%	Feb.	+44%	.7600	-32%	Government deficit up 30%, financed by external borrowing.	Sudan
Tunisia	Poor rainfall cuts 1983 cereal production to 960,000 tons, versus 1982's 1.3 million tons.	Mar.	-26%	8.1	1,240	May	390	-22%	1.3	0	First quarter 1983 trade deficit was \$420 mn., up from \$250mn. year earlier.	Mar.	+11%	Mar.	+18%	1.4925	-19%	France to provide \$65 million in aid this year.	Tunisia
Zimbabwe	World Bank to lend \$26.4mn. for highway construction and \$7.3mn. IDA credit for forestation.	Dec.	+ 1%	4.4	586	Mar.	130	0	1.1	154	Austerity required to meet conditions of \$324-million IMF standby credit.	Dec.	+12%	Dec.	+32%	1.0126	-26%	Overall government expenditure cut by \$206 million.	Zimbabwe
Kuwait	Government outlay on development projects holding steady.	Apr.	- 3%	24.3	17,350	May	4,728†	+13%	6.7	0	Domestic oil output avgd. 741,000 tons Jan.-April, up 16% from year earlier.	Dec.	+ 9%	Mar.	-18%	3.4129	- 2%	Govt. reportedly bought 10% shareholding in Volkswagen.	Kuwait
Oman	Seven-year, \$300-million Euroloan for development projects signed on June 6.	Apr.	- 1%	4.8*	5,372	Apr.	1,132†	+ 5%	16.8	0	Petroleum Development Oman made two new discoveries of light oil.	n. a.	n. a.	Oct.	+16%	2.8935	0	Oman Housing Bank raising \$43.4-million Euroloan.	Oman
Qatar	State's oil company to develop north gas field with two foreign partners; \$5 billion initial cost.	Apr.	-26%	6.0	24,000	Dec.	387†	+ 6%	2.3	0	Jan.-April oil output averaged 222,000 b/d down 32% from same 1982 period.	n. a.	n. a.	Dec.	+12%	.2747	0	Claims on private sector rising steadily.	Qatar
Saudi Arabia	New contract awards drop sharply during 1983 first half.	Apr.	-46%	155.8	16,719	May	28,834†	-11%	2.9	0	Trade surplus for 1982 put at \$38.2 bn., down from 1981's \$83 bn.	Dec.	+ 1%	Sept.	+19%	.2900	- 1%	Three industrial companies borrow \$188.5 million locally.	Saudi Arabia
United Arab Emirates	Central bank puts 1982 federal deficit at \$873 million, 40% greater than had been projected.	Apr.	-20%	29.8	29,780	Oct.	3,111†	- 2%	0	0	Abu Dhabi oil output avgd. 725,000 b/d in Jan.-April, down 24% from year ago.	n. a.	n. a.	Feb.	+ 6%	.2727	0	Gas liquefaction company to raise \$500-million Euroloan.	United Arab Emirates

*1980

**1982

†Excluding state reserves

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World Interest Rates

market rates as of July 13, 1983; bond yields as of July 6, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.51	n. a. intervention rate	9.00	9.50	4.00	17.00 penalty rate 20.00	4.50	4.00	5.50
Day-to-Day Money	9.125 July 14	9.25	8.875	6.80	12.188	5.10	17.854	5.25	4.00 1-month Euro-Swiss fr. rate	6.313
Treasury Bills 91-day, Middle Rates	9.05	9.23	9.375	9.25	n. a.	n. a.	16.451 170 days	no dealing	no market	5.375
Commercial Paper prime, 3-month, asked	9.375 finance paper discount basis	9.35 finance paper 15% tax w/h	9.143	8.90 Certified	12.625 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	9.55	9.30 15% tax w/h	9.438	8.90 Certified	not traded	5.00	18.55	no market	5.00	no market
Government Bonds Long-term, new and old issues, average yield	11.52	12.25	n. a.	9.84	13.46	8.30	18.55	8.84	4.52	7.11
Industrial Bonds prime, long-term, new and old issues, average yield	12.25 Aa Industrials	13.125	n. a.	11.19	14.82	8.25	17.62	8.93	5.85	6.53
Bank Short-Term Rate (prime rate)	10.50	11.00	9.50	13.25	14.55	8.00	18.75 1/4 qtrly fee on outstndg.	7.00	7.50	6.00
Bank Time Deposits 3-month	9.375 Cert. of Dep.	9.40	9.875	8.90	12.625	5.35	11.50	5.75 large deposits	4.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	10.312	9.688	10.00	no market	14.124	5.313	no market	5.75	4.938	6.563
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8119	1.529	.0193	.1284	.3862	.0007	.3452	.4714	.0042
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	0.640 P	0.418 P	1.390 P	4.05 D	5.282 P	7.351 D	4.635 P	5.600 P	3.753 P
Eurodollar Deposits (London, interbank, bid) July 14	7-day 9.500 1-month 9.688 3-month 10.063 6-month 10.438	International Arbitrage (3-month, hedged) + in favor of U.S. dollars				Eurobonds (average yield on recent straight debt issues)			Gold Price London afternoon fixing	
		U.S.-U.K. Treasury Bills -0.614				U.S. Dollar Bonds				
		U.S.-Canada Treasury Bills -0.489				7 yrs. and under			11.625	
		U.S.-Canada Finance Co. Paper -0.487				Over 7 yrs.			11.75	
		Eurodollars-U.K. Local Auth. Deposits +0.082				DM Bonds				
						7 yrs. and under			7.75	
						Over 7 yrs.			7.75	
									427.25 (per fine ounce)	

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(May) 3.5	(May) 5.1	(May) 3.7	(Jun.) 8.9	(Jun.) 2.4	(Jun.) 16.0	(Jun.) 2.8	(May) 2.9
Industrial production*	(May) 3.7	(Mar.) 2.6	(May) 2.3	(Apr.) -0.8	(May) -3.7	(May) -7.6	(Dec.) -8.5	(May) 2.3
Trade balance† (billions of local currency units)	(May) -\$6.91	(May) C\$1.63	(May) -£0.55	(May) -FF7.66	(May) DM3.62	(May) -Lit.410	(Jun.) -SF0.68	(May) ¥645.79
Money supply (M1)*	(Apr.) 10.5	(May) 7.9	(Apr.) 14.0	(Feb.) 9.9	(Apr.) 11.3	(Dec.) 16.4	(Mar.) 13.9	(Mar.) 5.3
Velocity of money (M1)*	(Mar.) -4.4	(Dec.) 0.4	(Dec.) -1.9**	(Sept.) 0.6**	(Dec.) -3.7	(Dec.) -1.8**	(Dec.) -5.2**	(Dec.) 0.8
Reserves minus gold (\$ million, change from previous month)	(May) -242	(May) -163	(May) 177	(May) 239	(May) -532	(May) 561	(May) 341	(May) 332

* Percent change from 12 months earlier.

** based on GDP

† Figures are only for the month indicated.

Indonesia Acts to Offset Lower Oil Revenues

Indonesian authorities wasted little time in acting to offset the effects of OPEC's oil-price cut in March. The decision to lower official crude-oil prices by \$5 per barrel worsened the prospects for Indonesia's balance of payments and threatened a sharp reduction in budget revenues. More fundamentally, however, the oil-price drop raised questions about the viability of the country's long-term economic development strategy. The government under President Suharto responded rigorously, adopting measures designed not only to cope with the immediate balance-of-payment and budget problems, but also to lead to a more balanced economy in the long-run.

The most urgent problem facing Indonesia as a result of the OPEC price move was how to arrest the deterioration in its balance of payments. Over the last two years the country's external position has been steadily weakening, primarily because of declines in net earnings from oil. By fiscal 1982-83, which ended March 31, net oil and gas revenues had fallen to \$7.2 billion from a peak of \$10.6 billion in fiscal 1980-81. This stemmed mainly from declining oil-export volume in an over-supplied market as Indonesia held closely to OPEC prices over most of the period. Stepped-up production of liquefied natural gas brought increased earnings which partially offset the lower oil revenues. However, in the same two years, earnings from other exports dropped by some 30% to \$3.9 billion, reflecting chiefly the world recession in commodity prices, but also the government's progressive ban on log exports. Exports of plywood—which had been intended to compensate for the restriction on log shipments—lagged, largely because of the depressed housing market in the United States. At the same time, imports were rapidly rising. The oil-price increases of 1979-80 had boosted Indonesian incomes, and capital goods had begun to arrive for the development projects spurred by the oil boom.

As a consequence, Indonesia's current-account balance shifted from a \$2.1 billion surplus in fiscal 1980-81 to a deficit of \$6.8 billion in 1982-83. This shortfall—about 7.5% of GDP—was financed partly by drawing on international reserves. By the end of the last fiscal year, as OPEC prices dropped, net reserves had shrunk to \$6.4 billion. The OPEC price decline posed the possibility that fiscal 1983-84 would see a still larger deficit. Since each \$1 drop in the price of crude oil subtracts around \$300 million from net oil and gas earnings, a current-account deficit of at least \$8 billion was not an unrealistic forecast. And with imports still rising, the government feared that the figure might rise as high as \$10 billion.

The OPEC price decline also promised a reduction in government budget revenue. In recent years, the

oil and gas sector has supplied 65%-70% of total revenues. During the boom years of 1978-81, revenues rose faster than expenditures, and some 4.5 trillion rupiah accumulated in government accounts. By fiscal 1982-83 the situation had reversed, and these accounts were being drawn down, despite a virtual freeze on government salaries and severe cutbacks in the subsidies on food, fertilizer, and oil products. The proposed budget for fiscal 1983-84 was brought in balance by again severely limiting expenditures—but under the assumption that OPEC's official benchmark price would remain unchanged at \$34. The price reduction OPEC subsequently agreed to would have thrown the budget into deficit by more than 1 trillion rupiah. And while this could presumably have been financed by drawing on accumulated cash reserves, the government sought ways to restore the balance.

Beyond these immediate concerns stood the larger issue of Indonesia's development program. During the late 1970s the government had moved by steps toward a strategy based on heavy industry. Capital-intensive projects underway or in planning by 1982 in steel, oil refining, petrochemicals, non-ferrous metals, and electric power generation, together with an array of supporting infrastructure, totalled over \$30 billion. The surge of oil revenue in the late 1970s made it possible to push that program forward and at the same time to devote enough resources to other objectives in order to increase rice production to near self-sufficiency, to raise standards of living throughout the country, and to provide jobs for most new entrants to the labor force. Declining oil revenues confronted government planners with hard choices and forced the sacrifice of some objectives.

Hard decisions and sacrifices

The Indonesian government reacted promptly and decisively to these problems. On March 30, it devalued the rupiah by 27.5%, to a rate of 970 per U.S. dollar. The new value restored the international competitiveness of the rupiah (as measured by the real effective exchange rate) to approximately its level of November 1978, after the last major devaluation. The 1978 devaluation was followed by a brisk—though brief—revival of non-oil exports, but an upswing of inflation quickly eroded its effect. Circumstances now, however, are different, and it seems likely that the inflationary consequences of the devaluation itself can be contained. The growth of credit has been kept within tight limits, and price reaction in April and May was less than expected. On the other hand, markets for Indonesian exports are weak; neither exports nor imports may be quick to respond. The short-term effect of the devaluation on the balance of payments

Indonesia Acts to Offset Lower Oil Revenues *(continued from page 7)*

is therefore problematic. Nonetheless, two other purposes should be served by the action: First, devaluation was meant to restore confidence and eliminate speculation against the rupiah so as to bring about a return of short-term capital. Second, it was intended to increase government rupiah revenues from oil and gas exports by an amount sufficient to offset the effect of the OPEC price decline. Success on both of these counts seems assured. However, because the effect of devaluation on the balance of payments is uncertain and probably not large in the short run, it was necessary that other measures be taken as well. The government realized this and within a few weeks enacted cutbacks in the country's development program.

The decision to pare capital projects was by all accounts a hard one for the government. First, it meant that the pace of economic growth, which had already slowed in fiscal 1982-83 to about 3%, would remain below previous expectations for some time. Second, it was difficult to determine priorities. Each major project had its own rationale—generally in terms of balance-of-payments earnings or savings—and many projects had already obtained foreign financing.

Despite the hard choices, the government enacted strong measures, affecting some 50 projects with a total cost in excess of \$20 billion. The exact impact of these actions on the balance of payments in fiscal 1983-84 cannot easily be determined. In many cases, where the project was only in the design or engineering phases, the savings to be realized will be chiefly from later years. The Indonesian government has estimated that the devaluation and project cutbacks combined will bring the fiscal 1983-84 current-account deficit down to \$6.5 billion. This level should be manageable with little or no additional drawdown of reserves, if the expected reflow of capital takes place. Already, in the first two months after devaluation, reserves bounced back to about \$7.2 billion, so this expectation seems warranted.

In addition, funding from multilateral sources and foreign-aid donors was assured at the recent Inter-Governmental Group on Indonesia meeting in the Netherlands. And financing from commercial sources is already well along thanks to the completion of a \$1-billion syndicated loan.

The remaining funding should not prove difficult to obtain. If necessary, Indonesia could call on the IMF. The country's credit balance with the Fund is currently very small and its quota of SDR 720 million would permit substantial borrowing. Around \$600 million could be obtained without conditions, much more on a conditional basis.

The measures that have been taken thus far seem to have brought short-term problems under control. They should also help to make the longer-term issues easier

to solve. Indonesia is still a heavily populated country whose labor force grows by nearly 2 million a year and whose food production has barely kept pace with consumption. A decade of rapid growth based on oil earnings made it possible to gain ground on these problems but not to solve them. They would become more difficult if GDP growth remained low for any great length of time. World Bank estimates suggest that growth of around 6% would be needed to absorb the annual increment to the labor force.

Long-run strategy

A strategy to achieve such growth in the 1980s and 1990s depends greatly on how important oil and gas resources continue to be to the Indonesian economy. In its most recent report on the country, the World Bank projects that net oil and gas earnings will revive in the second half of the 1980s and provide substantial support for the economy through the end of the century. This projection relies first on the Indonesian government forecast that oil production capacity can be raised from the present level of about 1.65 million barrels per day (mbd) to 1.9 mbd by 1990, and second, on an assumption that domestic consumption will grow at an average rate of around 4.5%-5% per year, that is, slightly slower than GDP. Given these assumptions and a forecast of a moderate increase in oil prices, real earnings from the oil and gas sector will rise by about 2% per year on average over the rest of the decade. Non-oil export earnings will then have to rise by an estimated 9% per year in real terms to support the desired GDP growth rate of 6%. In other words, there will have to be a shift of emphasis in the economy. The non-oil sectors will have to assume a greater role in supporting the balance of payments, providing employment, and generating savings and investment.

World Bank and Indonesian economists believe this can be done. Industry will need to develop in a more labor-intensive way to provide efficient import-substitution and exports. The plantation sector will have to be modernized and made more productive. Domestic savings will have to be mobilized to provide capital and impediments to private investment reduced.

There are signs that the government has already begun to prepare the way for such a strategy. It has announced that budget savings from project cutbacks will be applied to investment in labor-intensive projects. And in early June, a decision was made to eliminate most of the direct controls on bank credit and interest rates—a move which should help to stimulate private savings and channel them through the banking system. The readiness of the Indonesian government to undertake such measures is the best assurance that longer-term problems will be overcome.

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CHASE

International Finance

Vol. XVIII, No. 15
August 1, 1983

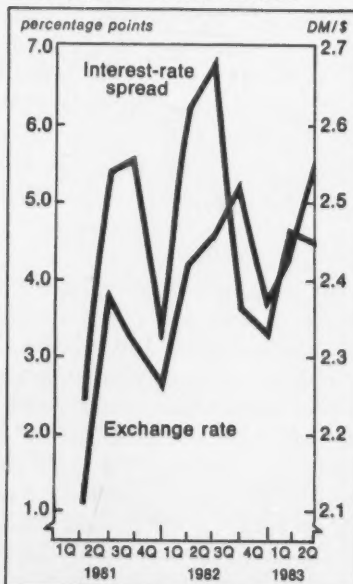
Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-15/13/83

NOTICE TO READERS

This is the final issue of International Finance. Please see note on page 3.

U.S.-German interest-rate differentials* and the DM-value of the dollar



*end-of-period values, defined in terms of 3-month Eurocurrency deposit rates

The Dollar: Strong for How Long?

Forecasters who look at "economic fundamentals" are debating the likelihood of a major fall in the dollar's value in the not-too-distant future. Broadly speaking, forecasters relying on fundamental analysis fall into one of two camps: those who project a major selloff of the dollar later this year or early in 1984, and those who argue that the dollar will be relatively strong for some time, although probably somewhat weaker next year than present forward rates suggest. The first group is inclined to stress the effects of the rapidly deteriorating U.S. trade balance. The second group tends to focus on the projected stability of relative monetary policies; these analysts argue that in such circumstances, anticipated interest-rate differentials, adjusted for inflation, will continue to support dollar-denominated assets as long as economic growth in the United States remains strong relative to other key-currency countries.

The fact that neither group is much inclined to dispute the other's main premise underscores the difficulty of making fundamental exchange-rate theory operational. Both groups adopt an asset-preference approach. But those focusing on the effect of the U.S. trade deficit stress differences in asset preferences between U.S. and foreign residents. Even more important to their analysis is the direct effect of a rapidly widening trade deficit on market perceptions of the relative rates of return on dollar- versus non-dollar-denominated assets. That is, they stress a market perception that the corrective mechanism for a widening international payments deficit is a depreciating dollar. In contrast, those focusing on the stability of monetary policy emphasize the likelihood that expectations regarding inflation-adjusted interest-rate differentials are unlikely to narrow and may tend to widen in an environment in which economic growth in the United States is relatively strong.

Whatever happens, however, neither of these arguments is likely to prove to be a very satisfying explanation of the dollar's movement. It is difficult to see the trade deficit itself becoming a *sufficient* condition for a major episode of dollar weakness. It is also hazardous to project U.S. money growth that continuously threatens the upper bound of the Federal Reserve targets, even if the pace of economic recovery remains strong. But what can easily be agreed is that in circumstances where U.S. interest rates appear likely to fall relative to rates abroad, a large U.S. trade deficit will make for a significantly greater weakening of the dollar than would otherwise have taken place.

Italian recovery hopes hinge on export turnaround.

As expected, Italy's June election resulted in no significant change in the make-up of parliament, and negotiations on the formation of a coalition government are now under way. The new government will face a difficult economic situation: Real GDP appears to have stabilized in the first quarter of 1983 after three consecutive quarterly declines. Fixed investment declined sharply in the first quarter, and more recent industrial production figures do not yet show clear evidence of any upturn. On a more positive note, monthly inflation rates have fallen, but in June the year-on-year rate stood at a still-high 16%. The trade deficit narrowed to 6.3 trillion lira over January-May, compared with 8.8 trillion in the comparable 1982 period. Nonetheless, the large public-sector deficit and double-digit inflation preclude any domestic stimulation. Consequently, official hopes for the recovery remain pinned to an upturn in exports.

Finland adopting firmer stance on economic policy.

When Finland's central bank raised its discount rate to 9.50% from 8.50% on June 16, it moved against the immediate general trend in the world toward lower rates. However, the previous reduction to 8.50% from 9.25%, made in June 1982, was part of a short-term policy package that led to negative real interest rates. The recent rise merely restores rates closer to their long-term trend. As bank lending has risen by almost 20% since the 1982 reduction in rates, this latest increase was by no means inappropriate even though the trade unions' organization and the Federation of Industries both criticized the action as a move that would increase industry's costs and refuel inflation. Finland's main policy changes, however, are still yet to come. The government's autumn budget is expected to include a small increase in taxation and a limitation on the growth of government expenditures to about 6% per year—a figure that would imply a small decline in real terms.

Colombia in midst of economic slowdown, accelerated peso devaluation.

Colombian economic growth has slowed significantly in the past two years, as a result of debt and foreign-exchange problems in neighboring Venezuela and Ecuador and the drop in its own export earnings as a result of the worldwide recession. The decline in services earnings and the difficulties Colombian industries have faced in competing against imported goods have worsened the slowdown. Growth of real GDP dropped from over 4% in 1980 to 1.4% in 1982 and almost no growth is expected in 1983. Inflation has moderated somewhat during this period of decline, with the rate falling to just over 20% in June 1983 from 24% last December. The pace of devaluation, however, has had to be accelerated to about 25% currently, owing both to the large devaluations in neighboring countries and to the strength of the U.S. dollar. This implies that Colombia is currently devaluing the peso in real terms and offsetting some of the currency's previous overvaluation.

Pakistan's balance of payments shows striking improvement.

Pakistan's balance-of-payments performance improved smartly during fiscal 1982-83, which ended June 30. According to preliminary estimates, exports may have risen as much as 13%. A sharp drop in traditional exports appears to have been more than offset by a sharp jump in non-traditional items arising from the rupee depreciation. Imports declined an estimated 0.7% in value because of additional import-substitution gains, a roughly constant oil-import bill, and minimal private-sector response to further import liberalization. With workers' remittances rebounding an astounding 28%, the current-account deficit narrowed to some \$730 million, or 2.5% of GDP, in 1982-83 from a revised \$1.61 billion in 1981-82, or 5.2% of GDP. And with net aid disbursements and loan drawdowns from the IMF up sharply, international reserves rose spectacularly to a level equivalent to more than three months of imports. Although a repeat of last year's performance would be difficult, another favorable balance-of-payments outcome appears quite likely in 1983-84—possibly a current-account deficit of under \$1 billion and a further addition to international reserves.

*Ireland's balance-
of-payments prospects
looking up.*

Irish spirits have been lifted by the announcement of a trade surplus for June—the first surplus since October 1975. This gives some further indication that the tough economic policies introduced in February's budget—and confirmed by the recent tax increases and expenditure cuts—are beginning to pay off. Other signs have shown up in the consumer price index, which posted a 9.8% rise for the year to May, compared with 17.1% and 20.4% in 1982 and 1981, respectively. Moreover, the current wage round suggests that there is some willingness to accept cuts in real wages. Ireland still has a long way to go, however, before it resolves its economic difficulties. Even if the trade account stays in surplus, the interest payments on the country's overseas debts will keep the current account in deficit for at least another year. Moreover, the trade surplus is partly the result of the slowdown in the domestic economy. But if the government is able to keep strict policies in place, there is a good chance that improving world-trade prospects will allow Ireland to expand the domestic economy in 1984 on the back of export-led growth. If all goes well, Ireland could see its current-account balance moving into surplus by the end of next year.

*Algeria insulates
economy from weak
oil and gas demand.*

Algeria has had reasonable success in cushioning itself from the weak conditions in the oil and gas market. In 1982, hydrocarbon revenues fell by only 10% to \$12.8 billion. This was achieved because over 35% of oil production was exported as refined products. Despite a 19% decline in exports of crude, refined exports increased by 97% to 17.7 million tons. In addition, following the successful conclusion of gas contracts with French, Belgian, and U.S. companies, LNG exports grew by 41.5% to 16.7 billion cubic meters. This also resulted in a 54% rise in condensate exports to 12.4 million tons. These developments, together with a generally conservative import policy, ensured that the deterioration in Algeria's balance of payments in 1982 was limited. It is estimated that the current-account balance thus moved from a small surplus of \$85 million in 1981 to a modest deficit of about \$1 billion last year. With further gas export contracts being finalized and condensate production rising, it initially appeared that Algeria's hydrocarbon revenues would rise in 1983. However, given the fall in oil prices—and the consequent decline of index-linked gas prices—as well as the recent desire by gas customers to reduce purchases, it now seems likely that 1983 hydrocarbon export revenues will remain at about \$13 billion.

With this issue, *International Finance* is ceasing publication after more than 17 years of reporting and analyzing developments in the world economy. The editors wish to express their thanks to the current contributors and support staff, who include: Carlotta A. Austin, Mark Babunovic, Douglas L. Bendt, Elizabeth Brennan, Angela Yvette Coe, Peter A. Davies, Richard W. Everett, A. Blake Friscia, Sharif Ghalib, Miguel Gomez, Robert F. Graboyes, Donald W. Green, Ronald A. Krieger, Melanie L. Lau, Thomas A. Lawler, Ronald G. Layard-Liesching, Benny P. Mah, George de Nemeskeri-Kiss, Nina Ramondelli, Dan C. Roberts, J. Nicholas Robinson, Vincent G. Salvo, Willard D. Sharpe, Susan Shawkat, Robert S. Slighton, Robert S. Smith, Lee R. Thomas, Laura K. Wallace, Terry S. Wiginton, D. Sykes Wilford, Gwendolyn Wright, and Sandra C. Zimmer, and to the hundreds of others who have helped to write, edit, and otherwise support the production of *International Finance* over the years. A special thanks goes to Robert F. Nestman of the printing firm of Guide-Kalkhoff-Burr for the skillful, creative, and dedicated supervision of all aspects of the production of every issue of *International Finance* since its inception in 1966.

The Chase Economics Group will continue to analyze international economic issues from time to time in *The Chase Economic Observer*, a bimonthly publication concerned primarily with trends and developments in the U.S. economy. Subscribers to *International Finance* who do not now receive the *Economic Observer* can be put on the mailing list by sending their address label to: Economic Publications, The Chase Manhattan Bank, 1 Chase Manhattan Plaza—28th floor, New York, N.Y. 10081, U.S.A.

Diana J. Rich
Managing Editor

Does the Discount Rate Matter?

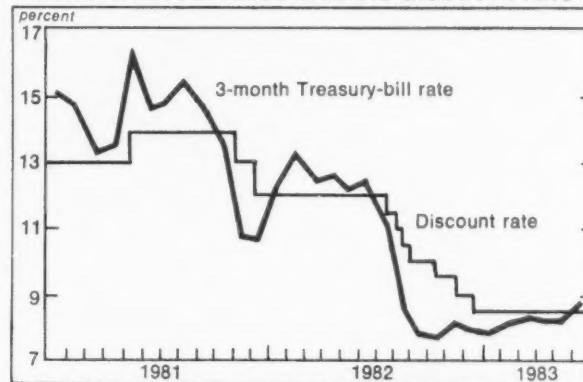
The Federal Reserve's announcement last month of new M1 growth targets helped to ease immediate pressures on the monetary authorities to raise interest rates in order to curtail money growth. Nonetheless, an increase in the discount rate sometime over the next few months may still be in the cards.

Fed-watchers disagree over exactly what role the discount rate plays in monetary policy. Some analysts argue that discount-rate changes signal the future direction of Fed policy. Others contend that the discount rate (which the Fed charges commercial banks on borrowed reserves) has no real policy role but merely is changed in reaction to the movement of other interest rates. In fact, there is evidence to support both points of view: Even though the discount rate does follow the movement of other rates, it is also true that a change in the rate provides information about future Fed policy.

Economists who assert that the discount rate has no influence as a policy instrument often point out that the Fed sometimes goes for long periods of time without changing the rate, and even then, the changes tend to follow rather than precede movements in market interest rates. The chart (right), which tracks changes in the discount rate against rates on three-month Treasury bills, appears to support the argument that adjustments

in the discount rate are made in reaction to market conditions—not the other way around.

Market interest rates and the discount rate



The opposite position—that the Fed does use the discount rate as a policy tool—holds that by changing the rate, monetary policymakers send a signal to the market about whether they intend to pursue a tighter or more-relaxed policy. If the discount rate is raised, the market should expect that the Fed wishes interest rates to stay at a higher level; if it is lowered, an easier stance can be expected. Unless both the di-

rection and the timing of the discount-rate change are accurately and fully anticipated by market participants, the action provides new information that will have a definite effect on market interest rates and ultimately on real economic activity.

The table (right) compares the closing rates on Treasury bills and certificates of deposit the day before and the day after a change in the discount rate. It is particularly noteworthy that in almost every case the discount rate led a change in the other two rates in the same direction. This suggests that adjustments in the discount rate do have a noticeable impact on market rates.

Disconcertingly, the evidence in the chart and the table, taken together, seems to suggest that the discount rate both leads and lags other interest rates. However, this is not a contradiction. In contrast to its use of open-market operations—which allow the Fed to move readily into and out of the market on a daily basis—the Fed is often more hesitant to make an adjustment in the discount rate. And because of this, the discount rate will generally follow market rates up or down. But because of this reluctance to move the discount rate frequently, any adjustment provides information about where the Fed believes interest rates *should* be. Thus, a change in the discount rate provides additional information to the market about possible future Fed actions.

Despite a substantial backup in market rates, the Fed has not changed the discount rate since last De-

Effects of discount-rate changes on other interest rates (percent)

Discount rate change	Treasury bills		Certificates of deposit	
	Day before	Day after	Day before	Day after
(5/5/81)				
13.00→14.00	16.01	16.52	17.55	18.29
(11/2/81)				
14.00→13.00	12.75	12.30	14.89	14.24
(12/4/81)				
13.00→12.00	10.52	10.22	12.00	11.43
(7/20/82)				
12.00→11.50	11.06	10.75	13.28	12.55
(8/2/82)				
11.50→11.00	10.17	9.80	11.92	11.28
(8/16/82)				
11.00→10.50	9.25	8.05	11.20	10.16
(8/27/82)				
10.50→10.00	7.14	8.16	9.72	10.27
(10/12/82)				
10.00→9.50	7.75	7.42	9.98	9.29
(11/22/82)				
9.50→9.00	8.10	7.95	9.03	8.74
(12/14/82)				
9.00→8.50	8.00	7.63	8.90	8.65

cember from its current level of 8.5%. This may be because it expects interest rates to ease somewhat over the next few months. However, if the Fed does finally raise the discount rate, the action will send an unambiguous message to the market that monetary policymakers feel rates should stay at a higher level.

Dan C. Roberts

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1982		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in \$ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes			central bank rate ^Δ in U.S. dollars	exchange rate July 27, 1983	current monetary conditions		
												latest data	consumer prices	latest data				money supply (M1)	
Austria	Real GDP now forecast to grow by 1% this year and 1.5% in 1984.	Mar.	— 5%	66.6	+1.1%	May	4,948	+ 6%	3.1	0	Current acct. surplus Jan.-May 5.6 bn. schilling vs. 700 mn. deficit year-earlier.	May	+ 2%	Apr.	+11%	3.75%	.0542	Interest rates remain steady.	Austria
Belgium	Manufacturing output shows signs of picking up as export prospects improve.	Apr.	— 5%	57.5	—1.9%	May	5,036	+51%	1.1	0	Trade deficit shrinking in wake of improvements in export competitiveness.	May	+ 8%	Dec.	+ 4%	9.00%	.0191	Interest rates easing.	Belgium
Britain	Retail sales up 6% from year earlier and some 2% GDP growth is expected for 1983.	May	+ 2%	505.8*	—2.0%	May	11,886	—12%	1.5	0	June current account was in deficit; year to date shows only a £33 mn. surplus.	June	+ 4%	May	+15%	9.375%	1.5225	Rates cut after election but upward pressures remain.	Britain
Denmark	Activity picking up; real GDP growth of 1.5% expected this year.	Apr.	+ 5%	54.5	+3.1%	May	3,345	+66%	2.4	0	Jan.-April trade deficit down to kr 1.1 bn., vs. kr 2.7 bn. year earlier.	May	+ 8%	Dec.	+13%	7.50%	.1059	Interest rates stable, but money supply now accelerating.	Denmark
Finland	Real growth of 2% still expected for 1983 after last year's 1% figure.	Mar.	0	47.8	+0.9%	May	1,001	—22%	0.9	0	Jan.-May showed 583 mn. markka trade surplus, vs. 1.2 bn. year earlier.	May	+ 8%	Mar.	+19%	9.50%	.1779	Central-bank discount rate raised to 9.5% in June.	Finland
France	Industrial production up in April and May; leading indicators down sharply; recession expected shortly.	May	+ 1%	568.5	+0.3%	May	18,701	+19%	1.9	0	Trade deficit on declining trend; exchange controls eased slightly.	May	+ 9%	Mar.	+11%	9.50%	.1270	Franc holds steady in EMS.	France
Germany	Activity levels off after strong first quarter; foreign orders remain extremely weak.	May	— 4%	659.7	—1.1%	May	45,004	+ 6%	3.5	0	Current account in surplus despite unfavorable trade-volume movements.	May	+ 3%	May	+10%	4.00%	.3817	Interest rates hold steady.	Germany
Ireland	Restrictive policies will hold 1983 GDP growth down to 0.5%	Dec.	— 4%	16.2*	+1.1%	May	1,884	—31%	2.5	0	June trade surplus narrows first half year deficit to 394 million pounds.	Feb.	+12%	Feb.	+ 5%	15.00%	1.2100	Rates have eased along with stronger position in EMS.	Ireland
Italy	Christian Democrats suffered setback in June election; parliament little changed; deficit still rising.	May	— 8%	345.6	—0.3%	May	16,612	+28%	2.3	0	Trade deficit declining as terms of trade improve.	June	+16%	Nov.	+18%	17.00%	.00064	Interest rates hold steady.	Italy
Netherlands	Industrial output recovers slowly; June inflation down to 2.5% year-on-year rate.	May	+ 2%	136.9	—1.7%	May	10,779	+23%	2.0	0	Mfgd. goods trade balance improving, reflects improved competitive position.	June	+ 4%	Mar.	+13%	4.50%	.3407	Interest rates ease as guilder strengthens in EMS.	Netherlands
Norway	GDP looks set for a small decline in 1983 after last year's 0.6% fall.	Apr.	0	55.6*	+0.8%	May	7,272	0	6.1	0	Officials forecast current-account deficit in 1983, but surplus widely expected.	May	+ 9%	Jan.	+ 7%	8.00%	.1336	Discount rate cut to 8% from 9% in June.	Norway
Portugal	New government launches austerity package.	Oct.	+ 1%	23.5**	+5.5%	Apr.	501	+44%	0.7	0	First-quarter current-account deficit \$670 mn. against year earlier \$1.09 bn.	Apr.	+21%	Dec.	+16%	23.00%	.0083	April consumer price inflation was year-on-year 20.8%.	Portugal
Spain	World recession and drought continue to inhibit recovery.	Dec.	— 1%	183.7*	+0.3%	Apr.	6,040	—35%	2.3	0	Jan.-May current-account deficit \$2.69 billion, up from \$2.47 billion in 1982.	June	+11%	Dec.	+11%	8.00%	.0067	Monetary policy tight; interbank rates over 25%.	Spain
Sweden	Export buoyancy contributing to the 1.7% growth expected this year.	Mar.	0	97.7	—0.1%	May	3,516	+ 3%	1.6	0	First half 1983 shows kr 8.6 billion trade surplus, vs. kr 2.9 billion year ago.	June	+ 9%	Dec.	+10%	8.50%	.1296	Rates steady since April's discount-rate cut.	Sweden
Switzerland	First quarter fall in GDP confirms fears of no economic growth this year.	Dec.	— 8%	101.5	—1.7%	May	12,667	— 3%	5.1	0	Trade balance improving, but first half-year deficit was still SF 4.5 billion.	June	+ 3%	Apr.	+10%	4.00%	.4760	Interest rates down as franc appreciates against DM.	Switzerland
Turkey	Output appears to be rising briskly; elections scheduled for November.	n. a.	n.a.	54.3	+4.4%	May	1,158	— 9%	1.4	1,657	Current-account deficit widened in first quarter as export-growth fell.	Mar.	+25%	Dec.	+40%	31.50%	.0047	Interest rates reduced but remain high in real terms.	Turkey
Canada	Economic recovery is now well under way.	May	+ 1%	282.9	—4.8%	May	3,471	+68%	0.7	0	Strong current-account surplus trend faltered in the first quarter of 1983.	June	+ 6%	May	+ 8%	9.50%	.8116	Policy constrained by monetary conditions in the U.S.	Canada
United States	Recovery gathers speed; consumer spending booms.	June	+ 5%	3,059.3	—1.7%	May	22,799	+15%	1.1	0	Trade balance moves further into deficit as oil imports rise.	June	+ 3%	June	+13%	8.50%	—	New monetary targets lessen chances of Fed's firming.	United States

*1981

**1980

△most recently reported

World Interest Rates

market rates as of July 27, 1983; bond yields as of July 22, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan																																																																													
Central Bank Discount Rate	8.50	9.51	9.375 intervention rate	9.00	9.50	4.00	17.00 penalty rate 20.00	4.50	4.00	5.50																																																																													
Day-to-Day Money	9.375 July 28	10.25	9.125	7.35	12.125	5.00	17.854	5.25	7.125 1-month Euro-Swiss fr. rate	6.50																																																																													
Treasury Bills 91-day, Middle Rates	9.07	9.26	9.313	9.25	n. a.	n. a.	16.315 92 days	no dealing	no market	5.375																																																																													
Commercial Paper prime, 3-month, asked	9.375 finance paper discount basis	9.35 finance paper 15% tax w/h	9.091	8.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded																																																																													
Bankers' Acceptances 3-month, asked	9.40	9.30 15% tax w/h	9.406	8.90 Certified	not traded	5.00	18.55	no market	5.125	no market																																																																													
Government Bonds Long-term, new and old issues, average yield	11.81	11.75	n. a.	9.86	13.19	8.25	18.37	8.71	4.53	7.092																																																																													
Industrial Bonds prime, long-term, new and old issues, average yield	12.55 Aa Industrials	13.00	n. a.	11.56	14.85	8.25	17.79	8.98	5.84	6.27																																																																													
Bank Short-Term Rate (prime rate)	10.50	11.00	9.50	12.50	14.55	8.00	18.75 1/8 qtrly fee on outstg.	7.00	7.50	6.00																																																																													
Bank Time Deposits 3-month	9.125 Cert. of Dep.	9.47	9.813	8.80	12.25	5.35	11.50	5.75 large deposits	4.00 residents only	3.75 20% tax w/h																																																																													
Eurocurrencies 3-month, asked	10.188	9.625	9.938	no market	13.688	5.188	no market	5.75	5.063	6.625																																																																													
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8115	1.529	.0191	.1269	.3813	.0006	.3411	.4733	.0042																																																																													
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	0.641 P	0.392 P	1.300 P	3.467 D	5.245 P	6.18 D	4.573 P	5.324 P	3.565 D																																																																													
<table border="1"> <tr> <td colspan="2">Eurodollar Deposits (London, interbank, bid) July 27</td><td colspan="3">International Arbitrage (3-month, hedged) + in favor of U.S. dollars</td><td colspan="3">Eurobonds (average yield on recent straight debt issues)</td><td colspan="3">Gold Price</td></tr> <tr> <td>7-day</td><td>9.563</td><td>U.S.-U.K. Treasury Bills</td><td>—0.507</td><td></td><td>U.S. Dollar Bonds</td><td></td><td></td><td>London</td><td></td><td></td></tr> <tr> <td>1-month</td><td>9.688</td><td>U.S.-Canada Treasury Bills</td><td>—0.498</td><td></td><td>7 yrs. and under</td><td></td><td>11.75</td><td>afternoon fixing</td><td></td><td></td></tr> <tr> <td>3-month</td><td>10.00</td><td>U.S.-Canada Finance Co. Paper</td><td>—0.488</td><td></td><td>Over 7 yrs.</td><td></td><td>12.00</td><td></td><td></td><td></td></tr> <tr> <td>6-month</td><td>10.438</td><td>Eurodollars-U.K. Local Auth. Deposits</td><td>—0.079</td><td></td><td>DM Bonds</td><td></td><td></td><td></td><td></td><td></td></tr> <tr> <td></td><td></td><td></td><td></td><td></td><td>7 yrs. and under</td><td></td><td>7.75</td><td>426.25</td><td></td><td></td></tr> <tr> <td></td><td></td><td></td><td></td><td></td><td>Over 7 yrs.</td><td></td><td>8.00</td><td>(per fine ounce)</td><td></td><td></td></tr> </table>											Eurodollar Deposits (London, interbank, bid) July 27		International Arbitrage (3-month, hedged) + in favor of U.S. dollars			Eurobonds (average yield on recent straight debt issues)			Gold Price			7-day	9.563	U.S.-U.K. Treasury Bills	—0.507		U.S. Dollar Bonds			London			1-month	9.688	U.S.-Canada Treasury Bills	—0.498		7 yrs. and under		11.75	afternoon fixing			3-month	10.00	U.S.-Canada Finance Co. Paper	—0.488		Over 7 yrs.		12.00				6-month	10.438	Eurodollars-U.K. Local Auth. Deposits	—0.079		DM Bonds											7 yrs. and under		7.75	426.25								Over 7 yrs.		8.00	(per fine ounce)		
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The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.

OPEC's investable surplus and the U.S. share

(billions of dollars¹)

	1978	1979	1980	1981	1982
Accumulated OPEC current-account surplus since 1974	160.0	214.0	321.0	373.0	365.0
Plus: Value of pre-1974 net foreign assets	17.0	16.0	16.0	15.5	15.0
Equals: Total net foreign assets	177.0	230.0	337.0	388.5	380.0
Plus: Net borrowing less lag in receipt of oil revenues	22.0	23.0	31.0	40.0	52.0
Equals: Investable cash surplus	199.0	253.0	368.0	428.5	432.0
Identified U.S. share²:					
Deposits in U.S. banks and other portfolio investments	35.2	43.6	56.7	69.8	81.1
Plus: Other U.S. placements	6.2	4.9	5.9	9.3	11.4
Identified direct investment	0.38	0.66	0.57	3.53	4.36
Plus: Deposits at major foreign branches of U.S. banks	21.2	29.2	30.0	27.3	20.8
Equals: Total U.S. share	62.6	77.7	92.6	106.4	113.3
U.S. share as a percentage of OPEC's total investable surplus	31.5%	30.7%	25.2%	24.8%	26.2%

¹at year-end. ²includes the relatively small investments of Bahrain and Oman, which are not members of OPEC.

Date: U.S. Department of the Treasury, Federal Reserve, U.S. Department of Commerce, and Chase estimates of investable surplus

OPEC Adjusts to a Current-Account Deficit

With the sharp drop in demand for their oil since 1980, OPEC members have seen a striking turnaround in their combined balance-of-payments position. After registering sizable annual surpluses through 1981, the OPEC current-account balance last year swung into deficit by an estimated \$8 billion, after official transfers (see table below). Currently, the aggregate deficit is expected to more than quadruple in 1983. And given the small likelihood of any major pickup in demand for OPEC oil over the next few years, these nations as a group seem destined to remain in the red at least through 1985. It is now clear that many OPEC nations have begun to draw down some of the foreign assets amassed since 1974 to help finance these deficits. And others are now using their investment income to cover current budget needs instead of reinvesting it.

OPEC current-account balance
(billions of dollars)

	1981 ¹	1982 ¹	1983 ²	1984 ²
Merchandise exports	267	205	172	202
Gross oil earnings ³	251	188	153	180
Non-oil exports ⁴	16	17	19	22
Merchandise imports⁵	-151	-149	-141	-152
Service exports	47	45	42	42
Investment income	35	31	27	25
Service imports	-92	-89	-87	-93
Transfers	-19	-20	-19	-19
Official	-8	-8	-7	-6
Current-account balance	52	-8	-33	-20

¹Estimated. ²Projection assuming oil prices hold at current levels. ³Excluding gas. ⁴Including re-exports. ⁵f.o.b.

Data: Chase Economics Group

The marked current-account reversal occurred despite significant retrenchments in the public spending programs of the OPEC nations that either noticeably slowed import growth or—in the case of Nigeria, Libya, and Iran—led to an actual import decline. OPEC's total outlays for imports of goods and services (and transfer payments) in 1982 fell by about \$4 billion to \$258 billion. This was, however, more than offset by a \$64 billion drop in export earnings to \$250 billion, resulting primarily from a 25% decline in oil revenues. OPEC oil production fell 18.6% last year to 18.4 million barrels per day (mbd), and the effective average price dropped 4.4% to about \$32.75 per barrel.

The continued soft demand for OPEC oil forced the cartel to reduce its "base" price by \$5 per barrel and to impose a production ceiling of 17.5 mbd on its members at a specially called meeting last March. OPEC's combined output has remained below that level. And oil ministers, at their regularly scheduled meeting in Helsinki last month, left the production ceiling unchanged. The aggregate current-account

deficit is now projected to widen dramatically to around \$33 billion in 1983. Moreover, for the first time since 1974, even the four Arabian Peninsula nations—Saudi Arabia, Kuwait, the United Arab Emirates (UAE), and Qatar, which over 1974-82 generated over 80% of the cumulative OPEC surplus—will register a combined deficit of some \$10 billion (see table below).

This expected further deterioration in the overall OPEC balance will occur despite additional budget adjustments by the members nations this year—particularly in Indonesia, Venezuela, Nigeria, and Iraq. Even the Peninsula states have been forced to cut back. OPEC's total current-account outlays are expected to fall by about 4% to \$247 billion. Nonetheless, the projected decline in overall export earnings will again be much larger—down 14% to \$214 billion—owing partly to a continued drop in income from foreign assets but mainly because gross oil earnings are projected to shrink further this year to about \$153 billion (based on assumptions that OPEC's 1983 crude-oil output will average just over 17 mbd and that prices will remain at current levels, yielding an average effective oil price of about \$29 per barrel).

Demand for OPEC oil is expected to rise in 1984. But, given that virtually all members of the cartel are currently producing at well-below desired levels, the most OPEC can hope for is that prices will fall no further. If oil prices hold, if OPEC output averages as much as 20-21 mbd, and if payments for imported goods and services, adjusted for inflation, can be held roughly constant next year, then OPEC's overall deficit will contract in 1984. It will, however, remain significantly large—probably \$15-20 billion.

OPEC current-account balance:
Regional breakdown
(billions of dollars)

	1980 ¹	1981 ¹	1982 ¹	1983 ²
Peninsula states ³	71.9	71.1	19.5	-10.0
Rest of Middle East and North Africa ⁴	24.4	-17.0	-11.4	-9.0
Other OPEC nations	10.6	-2.6	-15.7	-14.0
Aggregate balance	106.9	51.5	-7.6	-33.0

¹Estimated. ²Projection assuming oil prices hold at current levels. ³Saudi Arabia, Kuwait, United Arab Emirates, and Qatar. ⁴Iraq, Iran, Algeria, and Libya.

Data: Chase Economics Group

The shift in the overall current-account balance is already having an impact on the international deployment of OPEC's huge surplus. The table on page 6 shows how the growth of OPEC's gross foreign assets last year slowed considerably, compared with the rapid build up over 1978-81, as a result of the turnaround in the aggregate current account. Gross foreign assets—that is, the cash surpluses accumulated

OPEC Adjusts to a Current-Account Deficit *(continued from page 7)*

by OPEC's public and private sectors and available for international investment or other types of foreign placements—totaled approximately \$432 billion at the end of 1982. Government holdings accounted for about three-fourths of this total, and just over 80% of that represented the public assets accumulated by the four Peninsula states: Saudi Arabia, \$145-150 billion; Kuwait, \$72-75 billion; the UAE, \$28-32 billion; and Qatar, \$12-14 billion. These official assets include loans, but not outright grants, made to *non-OPEC* countries. The table calculates OPEC's accumulated investable cash surplus since the early 1970s and shows the known placements of OPEC funds in the United States and in major foreign branches of U.S. banks in recent years.

A further breakdown of the international disposition of OPEC's aggregate financial surplus during 1974-82, based on available data from various official sources, is given in the table below. These data indicate that the OPEC surplus actually *identified* as invested or loaned abroad (plus approximately \$3.1 billion placed in the United States before 1974) totaled the equivalent of \$376 billion—substantially smaller than the end-1982 estimate of OPEC's accumulated foreign assets on page 6 of \$432 billion.

The \$56 billion discrepancy is partly explained by estimation errors. However, the difference is primarily attributable to investments and other placements by the oil exporters *not* captured in the official statistics. These include: (a) unrecorded purchases of gold by both the private and public sectors, (b) trade credits given in exchange for oil exports, (c) OPEC deposits—especially by the private sector—in Swiss fiduciary (trustee) accounts, (d) sizable "loans" made by the Peninsula states to Iraq since 1980, (e) unrecorded joint-venture and other direct investment in some non-oil developing countries and in other

OPEC nations, and (f) last—but not least—*unidentified* financial and direct investment in the industrialized nations. In the United Kingdom, for example, the available data provide little information on OPEC investments outside of bank deposits and government securities. Moreover, some of the oil exporters' investments in the United States are not reflected in the official statistics because they are undertaken by third parties.

Changing patterns of disposition

Two aspects of how the deployment of OPEC funds has changed since 1979 are especially noteworthy. First, the proportion of new assets held in the form of bank deposits—particularly with U.S. banks—has declined sharply: from \$40 billion or 66% of the identified surplus in 1979 to a drawdown of \$16.5 billion in 1982. (Preliminary data indicate that there was a further drawdown of nearly \$8 billion in the first quarter of 1983.) This trend reflected both the growing preference for long-term investments (particularly in their U.S. portfolios) of the Peninsula states—which had already built-up strong liquidity positions—and the reserve drawdowns by the other members of OPEC to finance widening current-account deficits.

The second noteworthy aspect about what OPEC has been doing with its surplus is the marked increase in the U.S. share of non-bank placements by the OPEC nations—from \$2 billion or 10% of new investments identified in 1979 to \$9 billion or 44% last year. This reflects a renewed preference—mainly by the Peninsula states—for U.S. investment, which has been spurred in recent years by the strengthening of the dollar, higher real interest rates in the United States relative to Europe and Japan, the breadth and depth of the U.S. capital markets, and the expected relative strength of the U.S. economy over the long run.

Sharif Ghalib

Disposition of OPEC's identified financial surplus
(billions of dollars)

	1974	1979	1980	1981	1982	Total 1974-82
Identified financial surplus	56.0	60.9	86.6	49.7	3.9	372.9
Deposits in banks	28.7	40.0	41.2	1.2	-16.5	132.4
United States (domestic) ¹	4.2	5.1	-1.2	-1.9	4.4	14.3
United Kingdom (sterling)	1.7	1.4	1.4	0.4	1.3	5.5
Eurocurrency and other	22.8	33.5	41.0	2.7	-22.2	112.6
U.S. bank foreign branches	n. a.	8.1	0.8	-2.8	-6.4	20.8
Other investments	27.3	20.9	45.4	48.5	20.4	240.5
United States (domestic) ¹	7.3	2.0	15.4	18.4	9.0	75.1
Portfolio ²	6.6	3.3	14.4	15.0	6.9	63.7
Other ³	0.7	-1.3	1.0	3.4	2.1	11.4
United Kingdom	5.5	1.0	1.4	1.1	-1.1	8.6
Other industrial countries	11.04	8.7	17.0	19.4	6.6	137.9
Loans to LDCs		-9.6	6.7	7.2	3.9	
International organizations and gold	3.5	-0.4	4.9	2.4	2.0	18.8

¹Includes investments by Bahrain and Oman. ²Includes U.S. Treasury bills and bonds, federal agency bonds, corporate bonds, and stocks. ³Includes direct U.S. investment, prepayment for U.S. military exports, and non-bank liabilities. ⁴In 1974, loans to LDCs were not reported separately.
Data: Bank of England, U.S. Department of the Treasury, Federal Reserve, and U.S. Department of Commerce